THE CASE FOR PRIVATE INFRASTRUCTURE INVESTING

Introduction

Nikko Asset Management recently conducted an asset-class study of private infrastructure investing. This note summarizes our key takeaways in this study and touches on a few key questions for allocators relatively new to the infrastructure asset class, and to private markets in general. These include investors' expectations as to: asset-class characteristics, portfolio implications, target returns, risk considerations, investor landscape, and market conditions, which should provide a snapshot of the overall investment proposition for private infrastructure.

We believe that long-term oriented institutional investors could find investing into private infrastructure via actively managed funds an attractive investment proposition. This is due to private infrastructure's yield profile and return composition that could match with the investment orientation of long-term institutional investors. Furthermore, the inefficient and non-transparent nature of private infrastructure investing provides rich opportunities for skillful managers to add value.

Infrastructure as an asset class and portfolio implications

Infrastructure assets are broadly defined to be real assets that provide essential or commercial services to the public. They have predictable revenues/cash flows, often inflation-linked revenues, high barriers to entry, and inelastic demand for their services. Certain sectors such as energy and water utilities, transportation, social amenities (hospitals, schools) and some areas of telecommunications have the general characteristics of infrastructure assets.

Private infrastructure offers diversification from traditional listed portfolios but has a long investment horizon to capture full value uplift over the life cycle of the asset. For mature and operational assets, their stable cash generation helps to fund consistent yields to investors.

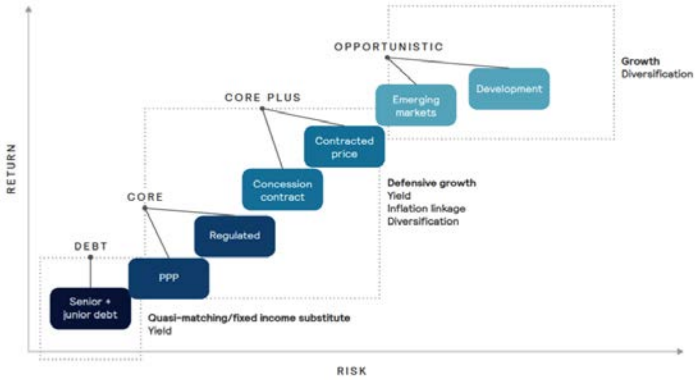
Listed infrastructure tends to provide less portfolio diversification given its higher correlation with equities, particularly over shorter time periods. The benefit of access to large infrastructure assets with a high degree of liquidity comes at the expense of higher performance volatility.

Types of infrastructure investment and associated risk-return profile

The expected returns from infrastructure investments (from capital appreciation and cash yields) are inversely correlated to the relative maturity of the asset base. There are different ways of accessing infrastructure investment across the risk-return spectrum (ref. Exhibit 1 below): from debt financing (senior to equity/fixed income proxy), core strategies (mostly brownfield, regulated assets), core-plus (brownfield with some growth), to opportunistic (development assets and/or emerging markets).

Debt financing of long-term projects mostly related to infrastructure or industrial manufacturing is based on forecast cash flow generation. There is increased complexity in valuing cash flows and evaluating credit risk which requires a greater level of due diligence. Both lower perceived risk for infrastructure debt versus equivalent corporate debt, and counter-cyclical properties (from studying historic default and recovery rates), offer diversification in fixed-income investment portfolios.

Exhibit 1: Risk-return spectrum for different infrastructure strategies

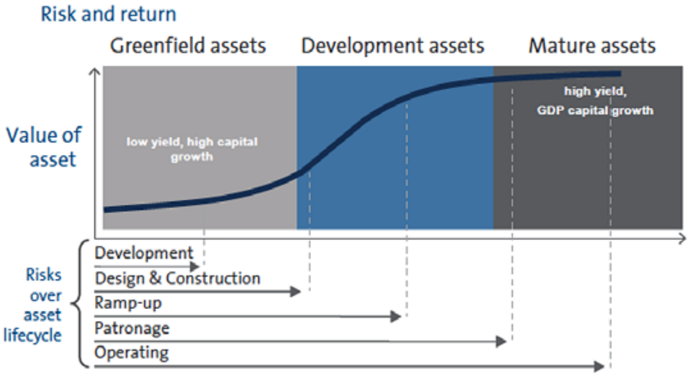


Source: Mercer, Mercer Infrastructure Primer, Aug 2016.

In tandem with return expectations, associated risk factors also evolve over the life cycle of the asset. Development and construction risks at the initial phase give way to ramp-up risk, followed by demand/usage risks (for assets not paid on an availability basis), and finally operating risk at the steady (mature) state.

Exhibit 2: Evolution of expected returns and risk factors over the asset lifecycle

Risk profile	Expected returns (IRRs)	Expected cash yields (%)
Core/mature	9% - 13%	7% - 12%
Core plus/growth	12% - 17%	5% - 9%
Opportunistic	15% - 20%+	3% - 5%



Sources: Mercer; AMP Capital, Understanding Infrastructure – a reference guide, 2013.

Many risk considerations are centred around fund structures, whether open-ended/evergreen or closed-ended/finite term funds. They are suited to deploy different investment strategies and have distinct benefits and drawbacks relating to liquidity terms, fee structures, and volatility implications, which also highlight the importance of independent valuations in fund management.

Fundraising landscape

Most private investment in infrastructure is institutional capital, given matching return profile/asset lifecycle for institutions with long-term liabilities. Infrastructure provides inflation-protected real returns, as adjustments for inflation are often built into operating agreements, and gives investors a gateway to tap into leveraged economic growth (especially in emerging markets).

The market is growing in terms of AUM, in light of the current trend for institutional investors to increase their allocation to infrastructure. A 2017 McKinsey study, based on Preqin's private markets database, found that infrastructure was the fastest growing asset class among private markets: fundraising for infrastructure grew 40% in 2016, driven by institutional demand.

In recent years, robust fundraising has led to record levels of dry powder and intensified competition for assets. The infrastructure AM industry is also becoming more bifurcated with the rise of mega-funds and capital becoming more concentrated at the top end of the market. Investors are attracted to the ability of the largest fund managers to source attractive deal opportunities, as well as their proven track record in deal execution and exiting investments.

Market outlook and investor considerations

Record "dry powder" levels, arising from the explosion of infrastructure-related fundraises, has led to intense competition for deals and stretched asset valuations. This highlights the ever-present need to diligence asset- and market-specific risks thoroughly, as well as rigorous modelling of project-level cash flows and returns, as higher entry prices leave less margin for error. Rising interest rates and market volatility also imply higher required rates of return for new projects coming online, as they will continue to be priced at a premium to prevailing risk-free rates.

On the other hand, infrastructure valuations are inherently less susceptible to market demand cycles. For instance, private equity are often valued using EV/EBITDA and similar metrics, which have significant correlation to public markets valuations (P/E). Because of the high visibility of future revenue streams and consequently free cash flow, asset projected returns and interim valuations are commonly based on DCF modelling, which is not dependent on publicly-traded P/E multiples, although cash flow projections could still be subject to volatility from the broader market environment. The onus of due diligence shifts from predicting favourable market conditions to specific risks to do with the counterparty, jurisdiction and asset operations.

The investment case for infrastructure is further underpinned by a sizeable global demand gap; McKinsey estimates at the current trajectory which projects public expenditure of c. 3.8% of GDP per year to meet demand through 2030, the world will fall short by USD 350bn annually. This gap triples when taking into account the additional requirements to meet the new UN Sustainable Development Goals.

As a final note, infrastructure investment is best suited to those with a mid-long term investment horizon and appetite for complex private markets investments, given the illiquidity and long lifecycle of underlying assets.

The above is comprised of excerpts from the full paper (Private Infrastructure: A Study) written in March 2018 by the Global Portfolio Solutions Group.

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