point of view

Infrastructure

Infrastructure has long been a popular asset class with the giant pension funds found in Australia, Canada and the US. In the UK it is growing in popularity but hurdles remain. Infrastructure hit the headlines late last year when the UK government announced its intention for pension funds to invest in infrastructure projects up and down the land. Here a panel of experts debate the latest thinking in the asset class.

Click here to listen to the panel discuss the issues.

How aware are UK pension schemes of infrastructure as an asset class? Are they investing and if so, how?

Giles Payne: Pension schemes gernerally have two different uses for infrastructure. One is the 'putting it in the ground' and the other is the mature infrastructure which generates a yield. I think for a number of years there has been a lot of emphasis put on the 'putting it in the ground' bit. (Going forward) there will be more demand for the mature infrastructure rather than 'putting it in the ground' infrastructure.

Toby Buscombe: We are certainly seeing more demand across our client base for brownfield, yielding infrastructure, rather than taking that construction risk up front. It is really only now we are seeing a lot of investors becoming aware of the asset class. So for them it is quite a long journey between that initial awareness and getting a meaningful investment.

Georg Inderst: Interestingly, infrastructure seems to be the area where there is both potentially very high supply of assets and a high potential demand for assets. I think the industry and probably the Government as well hasn't quite worked out and consolidated the best ways of matching the two. So far infrastructure as an asset class has gone very much through the private equity model, which obviously has brought a lot of investors into it.

Martin Lennon: People are generally comfortable with the debt side or the equity side. But what they really want is long-dated predictable cash flows, then they can make themselves comfortable with investing.

Is that where you are seeing the demand?

Martin Lennon: What the Government wants to see is more greenfield investors. It is not unique in its desire to have infrastructure in

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Martin Lennon


Giles Payne

"What the Government wants to see is more greenfield investors and therein lies the challenge." Martin Lennon

driving the rest of the economy and therein lies the challenge: greenfield development and infrastructure investing is quite a different beast than operational infrastructure investing and is to be honest a big step for institutional investors to make. But I think the benefit of having a deeper developed secondary market is not to be missed either.

Toby Buscombe: It is true pension funds have historically made some allocations to vehicles that have invested the greenfield end of the spectrum. Typically they have been private finance initiative (PFI) or public private partnership (PPP) focused managers. That is going to be important for the Government to bear in mind, as they are trying to harness capital for new projects; they are trying to deliver.

Giles Payne: The other issue is once you have got that secure stream of income, a lot of schemes aren't going to be around for the next 30, 40 years, so there has got to be an understanding of what can happen to these assets at a later date. Would insurance companies take them as part of the buyout process, or what?

Toby Buscombe: If you look at the boom years of the sectors, I mean 2005 to 2007, where we saw some very aggressive structures pursued by some managers, unfortunately we have seen investors burnt by that experience.

I think the challenge we all face as professionals in the industry is to educate investors that it doesn't have to be like that.

Martin Lennon: The experiences of the boom years actually put the sector in a much stronger place because there is a lot more understanding about the industry, for investors and managers. They won't tolerate the aggressive financial structures that we saw. The exciting thing for investors is there is a lot more choice now than there used to be.

Georg Inderst: The main thing governments should do is to make sure we get a good stream of suppliers' infrastructure on the market in an orderly way. Because then the investors can come in and have more supply; we wouldn't see those problems of the 2005 to 2007 period where there was shortage of supply.

Giles Payne: There is a duration mismatch between Government policy and investment horizon. If you look at the UK the energy market is being reviewed and reformed, to which the instant reaction is "Am I going to make a long-term investment decision in this environment?" The key is to come up with a structure to give the private sector and investors confidence making long-term investments.

Pete Drewienkiewicz: You could have something like a government-sponsored entity which effectively does all the investing and gets funding from the market in the best format it can. If that delivers the elongated, stable yield pension funds are after, which for most funds is probably more focused on the debt side than the equity side, that might be one possible solution.

Do you find pension funds are becoming more comfortable using the illiquidity premium?
Martin Lennon: Now we see banks with axed portfolios of assets who are looking to turn out in these liquidity swaps. You are starting to see an increased understanding from both the underlying market and pension schemes of what liquidity is worth. But clearly you don't want 100% of your portfolio tied up in liquid assets or restricted via these types of transactions.
Giles Payne: A lot of small schemes will just say, "I haven't got the first idea what you are talking about and haven't got the time; or the structures to do these things" because the quantity of assets being put into an arrangement like that isn't big enough. But pooling will mean infrastructure should be available to schemes of all sizes.
Georg Inderst: In the boom years all the focus was on the big funds, the big investors and smaller, medium-sized pension funds were not really very welcome. But I don't think we have reached the end of product development, particularly for smaller pension funds. The financial services industry needs to listen even more to what investors really want.
Pete Drewienkiewicz: It is not really surprising that commitment to infrastructure has ended up being slightly back-burnered. What is going to save you through an 07 or an 08, is it having 5% allocated to infrastructure? Or is it having got a handle on the major scheme risks a couple of years earlier? I think schemes have been focusing on putting out some slightly more necessary fires.
Toby Buscombe: The Government's budget is a real issue and when you have got a 0% to 5% target allocation to an asset class, each share of a finite government budget by definition is going to be very low. So actually getting people to spend the time and the resources on understanding it, figuring out how they are going to access the space, it almost becomes a self-perpetuating issue.

What about product development and availability? Are the options are there at the moment?
Martin Lennon: There are a number of fund managers that by their nature try and aggregate some smaller schemes, but even there I suppose the underlined checks they are taking probably are still quite significant. So development is coming. Canadians and Australians have made some huge allocations of 10% or 15%. What have they based that on?
Toby Buscombe: Across those larger, more highly allocated investors – certainly in Australia – the average fund sizes are quite a bit bigger and do support bigger internal teams. So a small team in Australia might be a dedicated six person investment team with somebody spending most of their time on, say, infrastructure and real assets and alternatives.
Pete Drewienkiewicz: There is a challenge there because obviously you don't want to get to the point where you have to start liquidating the stuff that you haven't had practice at.

"It is not really surprising that commitment to infrastructure has ended up being slightly back-burnered. Schemes have been focusing on putting out some slightly more necessary fires." Pete Drewienkiewicz


Pete Drewienkiewicz


Toby Buscombe

I think in the same way the private equity market has now got a very active secondary market there have been some trades in the infrastructure fund area as well. I can only see that growing.

Is this something schemes are talking about now?

Giles Payne: I have got one scheme looking to put about 10% of mature infrastructure to get an eight and a bit percent yield, because they have real direct knowledge in that. I have another scheme which bought two private equity-type structures and has had very bad experience over the last three or four years.

Georg Inderst: In the pitiful UK pension system most pension funds got rid of the internal investment resource in the 80s or 90s. UK pension funds used to invest much more in real estate directly and then moved out during that period. It then takes some time to restart the whole process and getting internal resources back in.

Toby Buscombe: I think you are seeing more investors at the larger end of town, looking to supplement their more traditional pooled exposures with some direct investing to increase their control over the way portfolios look and then how they are managed and liquidity options and things like that.

How far are we away from that?

Toby Buscombe: Ultimately people who are looking to make direct allocations need to be doing it with a very clear structure that provides for the ongoing management and recognises that these are dynamic assets, dynamic projects and do require active management.

Giles Payne: As an industry we look within what I would class as typically as the investment management industry, whereas actually some of the solutions might be within the private finance initiative (PFI) builders and providers – people who actually go out there, develop and run the projects.

Pete Drewienkiewicz: The challenge always with that kind of model is whether or not there is an inherent conflict of interest between a business whose core business is about making profits for building and operating assets, and an investor that is providing the capital to do so.

Georg Inderst: People forget that actually pension funds are quite heavily invested in infrastructure and utility through listed stocks. When they were privatised – usually utility but also with motorways in Spain and Italy – pension funds immediately picked those things up. They knew what they were into. They have been massive investors.

To what extent are investors looking at emerging market infrastructure?

Pete Drewienkiewicz: We are not an emerging market investor in infrastructure within my platform, but in the same way that investing in brownfield operation infrastructure is different from investing in the greenfield infrastructure, emerging markets is a whole different kettle of fish.

Toby Buscombe: There are some interesting emerging and peripheral

"Pension funds are already quite heavily invested in infrastructure through listed stocks." Georg Inderst


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Martin Lennon

markets for infrastructure around the world that have got some pretty well-structured projects. But for investors thinking about the space for the first time, that is certainly not where we would be suggesting that they allocate that first leak of capital.

Georg Inderst: It is an interesting question and one that actually you could turn the question the other way around. I hear that sovereign wealth funds and big pension funds from Asia are coming to London, coming to Europe and taking an interest in our infrastructure as a way of diversifying their currency reserve on that sort of investment.

Finally, what should pension funds consider before they decide to invest in infrastructure?

Toby Buscombe: It is important when investors are thinking about infrastructure the first time to pay heed to the fact that it is quite a heterogeneous, very loose grouping of assets. There is a huge range of different types of infrastructure in the market with their own liquidity characteristics, their own risk profiles, their own life spans. One of the areas where people have struggled and come unstuck today is by trading as a very homogenous asset class that just does one thing, then coming away somewhat surprised and disappointed when it didn't do that

Pete Drewienkiewicz: The people who are coming up with these propositions for pension schemes need to think very carefully about what has led pension schemes to consider these types of assets. It has been a failure of equity markets to deliver returns and a need to diversify their risks. Ultimately, you really want to be at one end of the risk spectrum and that is why the more debt-like propositions are more appealing than the more equity-like ones.

Georg Inderst: An interesting area to monitor will be the infrastructure bond market. There has been a lot of talk from the investment banks on this and you could say that the sort of utility index-linked bond is steady – an investment instrument for pension funds or for many pension funds, long-term, maybe 30 years.

Giles Payne: I think that the clarity of the offering is very important and even more important is the accessibility.

The structures in place and types of funds available need to be right to meet the objectives of the pension funds who are investing in it.

Overall it has the basis to be a very good asset class of pension schemes. It just needs to be structured right and targeted right and it will be successful.

All pictures: Richie Hopson

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