Infrastructure – The Next Asset Class

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Infrastructure investing allows investors to benefit from the construction and operation of a wide array of facilities that provide an essential service, such as transportation (roads, airports, pipelines) or utilities (water, gas, electricity).

The focus of this article is on the investment opportunities created by 'user-paid infrastructure' projects, which include facilities that involve an explicit payment by the user like highway tolls, landing fee or utility tariffs.

There are, however, infrastructure investment opportunities in other areas, such as "social infrastructure" projects, which are generally provided by the government and do not involve explicit user fees. Social infrastructure investments include public hospitals, prisons and schools.

User-paid infrastructure has particularly strong potential

Although social infrastructure is attracting significant investor interest in Europe through the Private Finance Initiative framework, it may not offer the same return potential as user-paid infrastructure. This is because social infrastructure projects have comparatively shorter-term operating spans and limited room for efficiency gains.

Within user-paid infrastructure there are a number of "Core" sectors, such as toll roads, airports, gas pipelines and electric transmission lines, whose attributes have a major impact on the way they are operated and financed. These 'Core' attributes include:

- Capital-intensive assets with long service lives;
- Essential service provision;
- Very high economies of scale resulting in natural monopolies;
- Fairly low operating risks;
- Low usage risk and low elasticity of demand;
- Predictable revenues based on stable usage.

PPPs and acquisitions driving returns

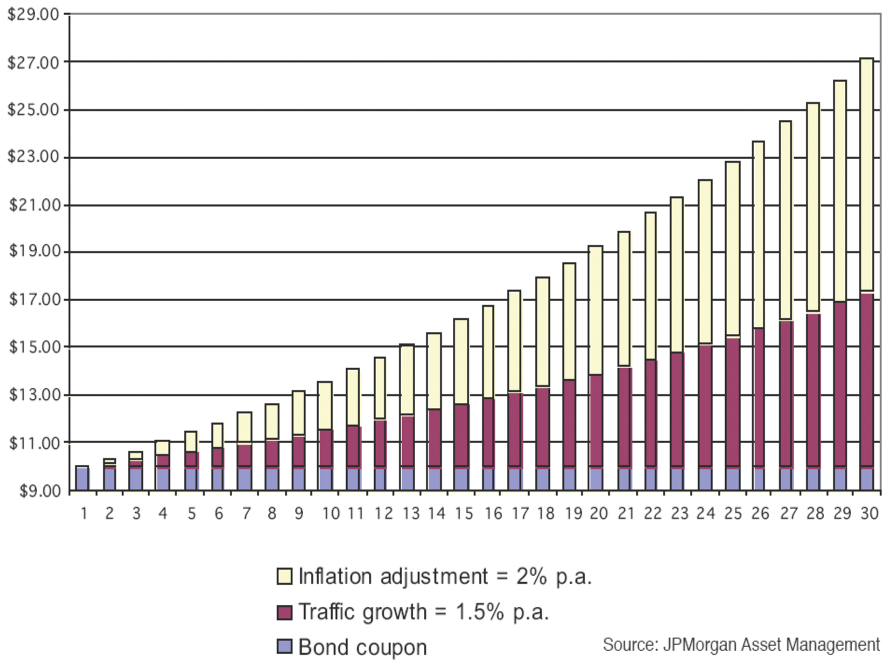
Some particularly strong user-paid infrastructure opportunities are currently found in the US, where faced with the prospect of diminishing resources for roadway investment, and encouraged by visible support from elected officials and global interest by investors and operators, federal and state authorities are increasingly using Public-Private Partnerships (PPPs).

PPPs are contractual agreements between a public agency and a private sector entity that allow greater private sector participation in project delivery and service provision. According to JPMorgan, the pipeline of US PPP projects is over £50 billion.

Infrastructure activity in Europe has also picked up significantly in recent years, with the total transaction value of projects, both equity and debt, standing at around £100 billion. However, because Europe has a long record of privatising toll roads, airports and telecommunication networks, privatisation opportunities may be more limited than in the US.

Fig. 1.

Comparison of a Fixed Bond Coupon and Concession Project Cash Flows



Source: JPMorgan Asset Management

Instead, established regulatory frameworks and market acceptance create opportunities for massive acquisitions, such as last years' £11.4 billion acquisition of BAA PLC by a consortium led by Grupo Ferrovial.

Investment considerations

Regulation

Facilities such as ports, airports, toll roads, railroads and transmission lines are similar to public utilities in that they provide an essential service, face little competition and have certain monopolistic attributes. For these reasons, some are regulated just like utilities and, as a result, their return magnitude is similar to a regulated utility with a significant component of cash yield.

Efficiency gains

In a situation where an asset is acquired from the public sector, the private investor may have opportunities for significant efficiency gains. In the toll road sector, introduction of electronic tolling by concessionaires is a prime example of such value added.

Inflation hedge

Current yield is typically a significant component of infrastructure's total return, which makes this asset class similar to fixed income investments. However, unlike typical fixed-income instruments, infrastructure offers a hedge against inflation. For example, many of the public agencies operating utility and transportation assets have an independent authority to adjust user fees for inflation and to pass through changes in certain operating costs such as fuel. Also, recent toll road concessions in the US allow toll escalation to compensate for inflation. The chart on the previous page illustrates the resulting project revenue growth (driven both by traffic and toll inflation adjustment) from the initial level equal to a fixed coupon payment

Diversification benefits

There is also some evidence that infrastructure as an asset class has low to negative correlations with several other asset classes. This suggests that a portfolio can reap diversification benefits from allocating a certain portion of it to infrastructure.

Investors should look for good regulatory frameworks in developed markets

Because many, if not most, of these infrastructure facilities are subject to some measure of rate regulation and expect the government regulator to preserve their economic balance to some degree, even in the case of termination, a reasonably established regulatory framework is essential.

Closely related to regulation is the need for a stable legal system to address regulation failures and assure a fair representation of the rights of all parties to project documents. Project experience of the past decade is rich with examples from emerging markets such as India, Indonesia, Brazil, etc. that highlight the circumstances impeding stable income flows to project sponsors.

Risks of investing in infrastructure

Infrastructure assets usually have one specialised use and do not easily lend themselves to conversion for alternative use. Therefore, depending on the point in the market cycle, it may be difficult to liquidate an investment at an acceptable price.

Regulation is also central to the operation of many infrastructure assets. For a utility-type entity, regulation directly determines its financial performance through the rate making process and matters of corporate governance. Overly restrictive or unpredictable regulation can severely undermine investment potential.

Furthermore, although risks are not as high for mature facilities as for greenfield ones, they are still present in the rate-setting process of regulated entities such as transmission lines, pipelines and some airports. Because the result of the exercise is a fee per unit (passenger, kW, etc) there may be a variance between forecast revenues and what is actually achieved.

Conclusion

We expect a continuing strong demand for infrastructure in OECD countries with limited government resources to fund it. In addition, a multitude of concession opportunities are expected in the US in the wake of several recent successful transactions.

Infrastructure segments which we have defined as Core have historically generated moderate, but stable returns with a significant current yield component. Their ability to deliver stable returns, along with their low correlation with other asset classes observed to date, provide a basis for recommending that investors consider making some space available within their portfolios for infrastructure investments.

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