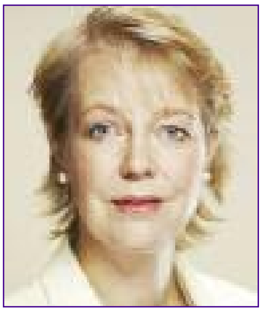
Listed infrastructure: an investment for uncertain times

INVESTING IS ALL ABOUT RISK AND RETURN. AND SO IT SHOULD BE FOR INFRASTRUCTURE. TODAY, HOWEVER, IT SEEMS IT IS ALSO ABOUT ACCESS.



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Many large institutions such as pension funds have been considering an allocation to infrastructure. We believe that infrastructure sits in two separate positions on the risk return spectrum. Infrastructure development is a high-risk investment, demanding the expectation of returns above that of listed equities. By contrast, infrastructure “ownership”, where you invest in mature assets with existing operations, should be positioned between listed equities and fixed interest in the risk/return space. Lower risk than general equities, but more risk than bonds. And its return? We think that the efficient, well-funded market that we have today should price this risk at about inflation plus 5% p.a. – again between bonds (inflation plus about 2-3% p.a.) and equities (inflation plus 7-8% p.a).

“Ownership” infrastructure is where Lazard seeks investment opportunities, what we call “Preferred” infrastructure, with key attractions for investors — longevity, low risk of capital loss, and revenues linked (explicitly or implicitly) to inflation.

In these still uncertain times, investors will continue to look for opportunities to allocate capital to stable asset classes and high-quality, long-term investments. Infrastructure assets offer such an opportunity, as people will continue to commute to work (toll roads, rail lines), turn on the water (water utilities), and power homes and businesses (transmission and distribution grid) even during an economic downturn. In particular, Preferred Infrastructure has attractive characteristics, namely those that might leave investors with their real capital intact and with satisfactory total returns in the face of inflation and deflation while providing a reasonable return in the interim. These attractive characteristics are:

- Ownership of real assets.
- Stable demand.
- Pricing power.
- Generous operating margins.
- Manageable debt.

But as we noted at the outset, investing in infrastructure is also about access. There are two main ways to invest in infrastructure: direct – that is through unlisted or private equity investments, or listed – that is through stocks quoted publicly on stock exchanges. Importantly, the characteristics of the assets themselves do not change regardless of whether they are held directly or via an exchange.

Given a choice between the same assets (absent considerations such as liquidity and fees etc.), at the time that the investment decision is made an investor should be indifferent as to how they are held. Investors should be more concerned with their entry point (i.e. the prevailing market valuations of the assets at the time they are investing) and the prospective risk-adjusted return.

The Global Listed Infrastructure team believes that today, listed infrastructure is selectively very cheap compared to history. There is a mountain of capital seeking infrastructure investments on a direct basis, and not only are the major funds looking for opportunities, there are a plethora of funds that have been formed to take investors into infrastructure. Despite this plethora of direct unlisted managers available, the total market size of listed infrastructure is at least five times the size of the total unlisted market.

The mountain of undrawn equity capital commitments that direct infrastructure managers are sitting has been raised between 2006 and 2008 when there were high return expectations premised on cheap debt and high levels of leverage. The global financial crisis has seen cheap, abundant debt disappear, and consequently the rate of new equity investment has fallen. We believe investors with existing undrawn commitments to direct infrastructure may not get fully invested with the total balance of undrawn commitments of direct infrastructure totals more than US$100 billion.

We estimate it would take 20 years for the existing undrawn commitments to be fully invested, assuming no further capital raising and the same buoyant market conditions that existed during the period 2000 to 2009 applied in the future.

We believe the main reason for the significant drop in investment is the collapse of debt markets in 2008, and the subsequent tightening of lending criteria and leverage levels in 2009. Why is debt important? In order to achieve an equity return of 12% per annum or greater in a fairly-valued marketplace for mature infrastructure, it is necessary to use a leverage ratio greater than 50%. Put simply, the tightening of credit markets has meant there is insufficient debt available for direct investors to meet their target equity return hurdles, and consequently, the investment of committed capital has not been made.

An attractive alternative to investing in direct infrastructure is investing in listed Preferred Infrastructure. Currently, this offers excess risk-adjusted returns, transparent and competitive fees, and, importantly, suffers no issues with regard to delays in getting fully invested. Looking back at its four year period of operation, our investment strategy (which focuses on Preferred Infrastructure) has outperformed the MSCI World Index (MSCI) and the UBS Global 50:50 Infrastructure & Utilities Index in Local Currency. It has achieved this with consistently lower standard deviation (strategy 15.6% p.a. vs. the Index 19.2% p.a. and MSCI 20.2% p.a.), and a daily beta to the Index of 0.6 and MSCI of 0.5.

The Global Listed Infrastructure team believes that investment returns promised by direct managers have been too high. With the tight credit markets that now prevail, these managers will no longer have access to sufficient cheap debt to meet equity return targets, and it is likely there will be a persistent overhang of undrawn capital. Preferred Infrastructure is an attractive alternative for investors, providing immediate access to companies with inflation-protected, stable revenues that on our own assessment, offer a 30% discount to a fair risk-adjusted return.

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