Infrastructure investing: the benefits and risks

OVER THE LAST DECADE, INFRASTRUCTURE HAS RISEN TO PROMINENCE AS AN ASSET CLASS IN ITS OWN RIGHT. BUT WHAT IS DRIVING THE INTEREST IN INFRASTRUCTURE, AND WHAT DO POTENTIAL INVESTORS NEED TO BEAR IN MIND? PETER CAZALET OF J.P. MORGAN EXAMINES THE POTENTIAL BENEFITS OF INFRASTRUCTURE INVESTING, ASSESSES THE RISKS, AND DISCUSSES HOW THESE RISKS MAY BE MITIGATED

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Infrastructure can be defined as the essential facilities and services upon which the economic productivity of society depends – facilities and services such as airports, bridges, toll roads, water systems and power generation. As such, it is almost impossible to overstate its importance to global governments and companies.

There is a huge and growing global need for governments to finance, maintain, modernise, expand and develop the infrastructure facilities essential to ensuring continued growth in economic activity and productivity. For example, it is estimated that USD 16 trillion will be required to modernise and expand water, electricity and transportation systems in the US, Canada and western Europe over the next 25 years (source: Booz Allen Hamilton).

With budgets increasingly stretched, governments have begun to recognise that private sector capital can be used to help satisfy their infrastructure needs, allowing them to focus existing limited resources toward other vital functions within their communities. This trend presents significant opportunities for investors to acquire and manage high-quality infrastructure assets around the world.

Compelling investment opportunities

Investors are increasingly recognising the attraction of infrastructure investing due to the unique characteristics of the asset class, which offers long-term exposure to relatively stable, economically insensitive, inflation-protected cashflows, providing growth potential and strong diversification benefits.

Because infrastructure assets supply essential services, they demonstrate a usage pattern similar to non-discretionary consumer goods. Rates charged for infrastructure services are affordable and are set at levels below monopoly prices, meaning usage does not significantly decrease during periods of economic weakness or when rates are increased. For example, electricity demand in the US has increased steadily since 1974, regardless of the economic environment or price of electricity. The estimated price elasticity for residential electricity consumption is -0.05 – meaning a 20% increase in price results in just a 1% drop in consumption (Source: EIA, J.P. Morgan).

As a result, infrastructure demand is often very stable – meaning cashflows from infrastructure investments are also relatively stable compared to cashflows in many other asset classes.

Essential for economic development

Another consequence of the essential nature of infrastructure assets is that governments are increasingly focused on ensuring that essential services (such as water and sewerage systems, electricity networks, and airports) are available in good condition and are consistently reliable.

The link between the availability of infrastructure services and economic productivity is well established – a key reason why governments across the developing world are making provision of infrastructure a high priority. In the developed world meanwhile, any stoppage or malfunction of infrastructure results, quite rightly, in public concern and outcry, as observed for example in the California electricity crisis of 2000 and 2001, the Paddington train crash of 1999 in the UK and, more recently, the Minnesota bridge collapse in 2007.

Booz Allen Hamilton has estimated that USD 40 trillion will need to be spent over the next 22 years to replace the ageing infrastructure required to accommodate growing and underserved populations. But many governments are not in a fiscal position to meet this spending need alone. Budget constraints continue to worsen, with tax receipts falling due to faltering economic growth, while debt issuance remains difficult due to poor credit market conditions and debt ceilings. As a result, governments are increasingly looking to private capital to help them meet their infrastructure spending needs – and are therefore also increasingly recognising the need to allow private investors to earn a fair return.

This demand for private sector involvement helps to ensure that the infrastructure asset class has the potential to provide attractive long-term returns, and is helping to open up further compelling investment opportunities in the asset class for astute investors.

Inflation protection

One of the most compelling reasons to invest in infrastructure is its ability to provide inflation protection. The rates that are charged for infrastructure usage are usually linked to inflation, meaning an investment in infrastructure assets can provide inflation protection. Utility prices, for example, are often determined by regulators, who set the allowed return on equity based on the necessary capital and maintenance expenditures. All variable costs – such as the cost of wholesale natural gas or electricity – are passed through to end users, protecting the return to investors from the effects of cost inflation. Similarly, transport rates – rail or bus fares – are usually linked to inflation.

To demonstrate this inflation protection characteristic, we analysed the performance of the annual cashflows (measured by EBITDA) of 256 mature infrastructure assets in the US and European Union from 1986 to 2008. Cashflows grew steadily, at a rate above inflation (as measured by the consumer price index), regardless of the global economic environment.

We also observed that these cashflows were lowly correlated with those of equity and real estate, as a result of the particular characteristics of infrastructure investing (stable demand, economic insensitivity and inflation protection). Adding infrastructure assets to a portfolio therefore provides attractive diversification benefits.

Mitigating the risks of infrastructure investing

Of course, as with all investments, infrastructure investing also has its own unique risks that investors should bear in mind. Indeed, each infrastructure sub-sector has its own risks. Sub-sectors are regulated by different governing bodies and have varied economic sensitivities – a seaport, for example, is more dependent on trade and economic activity than residential water usage is.

However, this diversity among sub-sectors can be turned to investors' advantage. Correlation among sub-sectors is relatively low – toll bridge traffic, for example, has a very low correlation to residential electricity consumption, as one may expect – so much of this sub-sector risk can be mitigated by creating a well diversified infrastructure portfolio.

It is also important to bear in mind that infrastructure investments can be less liquid than many other assets and are best suited for a long-term investment strategy. Individual infrastructure assets are usually larger in value than real estate assets and have a smaller universe of potential buyers. Because of the extensive due diligence effort and regulatory approval these assets typically require, divestiture of an infrastructure asset may take a considerable amount of time and substantial resources.

Investors can gain exposure to infrastructure assets through a number of vehicles with varying liquidity terms. Open-ended funds generally take a very long-term investment approach and may provide investors with more liquid exposure to infrastructure relative to closed-end funds.

When choosing an infrastructure investment, investors should also be aware that they may be exposed to leverage, and the associated risks. The cashflow potential of infrastructure assets may present opportunities to boost return on equity via leverage at the operating company level. Credit market conditions impact the amount, cost and terms of credit available to infrastructure assets. Managers can mitigate this risk by making conservative refinancing assumptions when underwriting, and employing leverage prudently – in quantity, structure and tenor.

As with global investment in any asset class, diversifying infrastructure investments across countries generally provides benefits to a portfolio. However, such an approach also adds exchange rate volatility to returns. Exchange rates, especially between currencies of similarly developed countries, generally revert to the mean in the long run, so for long-term investors in core and core-plus investments, short-term exchange rate fluctuations have less importance. Depending on availability of information, it is often possible for investors to cost-effectively hedge this exposure with a currency overlay. Investing in a fund with explicit diversification guidelines limiting over-concentration to specific geographies can also help to lessen currency risks.

Finding the right investment partner is essential

Finding a manager with the expertise to choose the right infrastructure assets is vital in mitigating risk. Regulatory environments can vary significantly from one asset to another, so managers must have a strong understanding of political, regulatory and legal environments in various geographies and sub-sectors. In addition, the type of vehicle through which investors gain exposure to infrastructure can serve to mitigate liquidity and capital market risks.

For investors prepared to take on the risks, an investment in infrastructure provides strong benefits – notably steady cashflow, inherent inflation protection and low correlation to other major asset classes. Among institutional investors in particular these benefits are being recognised, as we've seen, due to the ability of infrastructure investments to provide a good match for liabilities, as well as attractive long-term returns.