For Investment Professionals only

Institutional Investment Intelligence Q&A Infrastructure Equity

with Carolyn Pearce, Investor Relations Director, Infracapital

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1. What type of infrastructure does Infracapital invest in?

We look at all types of essential infrastructure and aim to build a diversified portfolio of long-term assets. Infrastructure encompasses many types of physical assets forming the backbone of an economy, assets that provide essential services to the public across a number of different sectors including:

- Utilities such as water companies and gas and electricity providers
- Renewable energy providers encouraged to deliver low carbon-based energy
- Transport infrastructure and networks such as ports and roads
- “Future” infrastructure - Technological change is driving many opportunities including new distribution networks, to meet a changing energy mix and also, increasing perceived essentiality of certain services such as high-speed broadband
- Social infrastructure, including educational establishments, social housing and medical facilities, low risk investments benefiting from long-term government contracts. This has become a highly sought market sector therefore we tend not to invest in the sub sector and instead target operational assets where our hands-on approach and expertise can deliver superior value

2. What is Infracapital’s approach to investing?

Infracapital offers multiple ways to access essential European infrastructure, with all strategies ultimately aiming to deliver stable cashflows and long-term capital value to investors.

We believe we are uniquely positioned to access opportunities, with a multinational team who have spent substantially all of their careers in the sector. We are well placed to build fully diversified portfolios, leveraging our bilateral sourcing capabilities, offering premium value on entry and benefiting from our connections with the wider Prudential Plc group. Our focus is in Europe, where significant opportunities exist. Strong relationships and a deep understanding of the local market dynamics including, crucially, the political and regulatory landscape are critical to executing and delivering on our strategies to investors.

For Greenfield opportunities, where completely new projects are built, we typically aim to invest after the planning, design and consultation phases have been processed, rather than at inception. We therefore avoid the development period where returns could be zero, and only invest once we have visibility over the success of the project, and strong confidence in the operating cashflows ahead. That way we can target attractive returns, while avoid working to the riskier, early stages.

In the Brownfield sector, given increasing capital inflows generally, we aim to capitalise on the opportunities that attract less attention from acquirers with lower costs of capital, who can pay prices unattractive to us. We continue to find superior value in more complex transactions, which might require separation from a parent company or more hands-on management oversight, enabling our dedicated asset management team to add significant value.

3. How do you identify worthy transactions?

Owing to the strength of our reputation in the market and the extent of our networks, we look to source our investments on a bilateral basis. Interesting opportunities may arise through discussions with any of our market contacts, be they bankers, lawyers, developers, business owners, competitors, government officials or even existing investors. However if it is a more competed process we only participate where we are positioned strongly and have a unique angle. We have experienced success in off-market transactions at much lower EBITDA (earnings before interest, tax, depreciation and amortisation) multiples than on the open market.

4. What do you consider the greatest risk factors when investing in infrastructure?

As well as the endogenous risks inherent to the asset, such as completing construction and the ongoing risks associated with the operational stages, exogenous risks, such as regulation, must always be considered. Governments will often focus on customer affordability which may threaten any permitted regulatory return. At worst, governments could implement retroactive changes to contracts and terms, which undercut the viability and value of a project. While this has happened in a limited number of jurisdictions, most governments will refrain from changes that ultimately deter private sector investment, given the scale of the investment requirements most governments face.

Disruptive technology and rapid technological advances may pose a risk in some areas of infrastructure. Renewable energy is having a disruptive effect in the electricity sector and technological advances such as driverless cars could affect established assets such as car parks.

5. How do you see the current market and the drivers of its growth?

Investing in long-term, private assets, such as infrastructure, is becoming increasingly popular for long-term investors. They recognise infrastructure's compatibility with their liability objectives in addition to its apparent ability to consistently generate strong returns in unstable market environments, resulting in a significant increase in demand for such assets.

In addition to an increasing supply of capital, there is also a need for more investment in infrastructure. Governments are keen to unlock private sector financing for much needed new infrastructure projects.

In late 2016 the European Council approved an extension, to 2020, to the European Fund for Strategic Investments (EFSI), otherwise known as the "Juncker plan". It simultaneously increased the target for new investment across the European Union to €500 billion, from €315 billion. Estimates of the scale of the global infrastructure need vary, but in October 2016, Citi, the US bank, suggested that US$58.6 trillion of global infrastructure spending would be required, in the period to 2030, to achieve the OECD forecast growth rate of 3.8% p.a. (source: Citi GPS: 'Infrastructure for Growth').

Therefore, while capital inflow will mean some high profile 'trophy' assets trade very expensively, there is still a significant flow of opportunities for essential infrastructure investment enabling the more sophisticated and experienced investors to achieve attractive returns.

6. What features are considered attractive to investors and what are potential rewards?

Essential economic assets can deliver stable and often predictable returns, which is a key attraction of infrastructure to an investor. Infrastructure assets offer resilience through economic cycles and in many cases represent monopoly type businesses with barriers to entry for potential competitors and to exit for customers. Typically, returns are relatively uncorrelated to other asset classes thereby adding valuable diversification to an investor's portfolio.

Cashflows can be contractual and predictable, with links to inflation so, increasingly, pension schemes recognise that infrastructure can help them to meet their long-term liabilities. Infrastructure has the capacity to offer investors more than just income, with significant capital growth possible, especially in relation to greenfield investments.

7. How is investor demand developing?

Pension funds from Australia and Canada have been significant and highly-visible infrastructure investors for some time. Institutional investors in the UK and Europe are also becoming increasingly active, attracted by key features of the asset class.

Brownfield investments are popular, often considered to be safe investments and, due to their already-operational nature, are able to deliver cashflows from the outset. Greenfield opportunities are complementary, targeting higher returns relative to core brownfield, with the objective of rewarding investors for participating earlier in the project lifecycle.

Long-term investors, including institutional pension funds, have gradually increased their allocations to infrastructure in recent years. The advent of pooling for UK local authority pension funds may provoke additional infrastructure investing, as potentially having greater scale in the market may expand the opportunity set and appetite. The appetite for co-investment persists and is considered attractive for investors who wish to increase their exposure to certain investments. While infrastructure assets have attractive anti-cyclical characteristics, they remain big, complex operating businesses that require an experienced manager to drive operational efficiencies and generate value.

8. What are the main challenges we face as investors in infrastructure?

The current popularity of the asset class can, itself, pose a challenge. Significant demand for assets can impact the chances of generating attractive returns. Some investors that enjoy a lower cost of capital, such as direct investing pension schemes, may be able to accept lower prospective returns, hence they can bid up the prices of assets to levels we find unappealing. Therefore we need to spend our time, using our network, to identify off-market opportunities, or to participate in more complex transactions, which require the expertise we possess, to complete.

9. How would you describe Infracapital's strengths?

Infracapital believes it is uniquely positioned as an infrastructure investor. We are able to operate very much like a boutique with a direct alignment to the client's interests. At the same time, we enjoy the overarching benefits of being part of the larger Prudential Plc group.

Infracapital prefers to source investments in areas of the market where the larger, or low cost of capital, investors typically do not participate, and where competition does not meaningfully erode prospective returns. We aim to focus our attention on investments in the mid-market (deals of up to £1 billion Enterprise Value) and on transactions which are complex or more difficult to procure. Thus we are able to leverage the capability and experience of the team to continue to target attractive returns, while continuing to invest in the core space. Testifying to this, more than half the investments in our most recent fund were sourced off-market and have been performing well, in spite of a competitive environment. Another unique feature is our ability to invest early in the infrastructure life cycle, in a diversified offering across a number of market sectors. This can provide multiple ways for investors to aim for attractive returns while ultimately gaining access to essential infrastructure assets and the appealing qualities they offer.

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