MFG ASSET MANAGEMENT

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Institutional Investment in Infrastructure

Discussion paper on the relative merits of private-market vs public-market approaches

Infrastructure is an appealing asset class: When strictly defined, it delivers stable, inflation-linked returns, above those offered by inflation-linked bonds, with risk below that of equities. Because of these characteristics, institutional investors have significantly increased their allocation to the infrastructure asset class over the past decade. Generally, this increase has been achieved through assets managed by specialist infrastructure private equity managers. However, more recently, financial market instability and the realisation of the importance of liquidity has caused strategies that focus on public-market assets to become more popular.

This paper discusses the relative merits of private versus public infrastructure investment.

Illiquidity and Returns

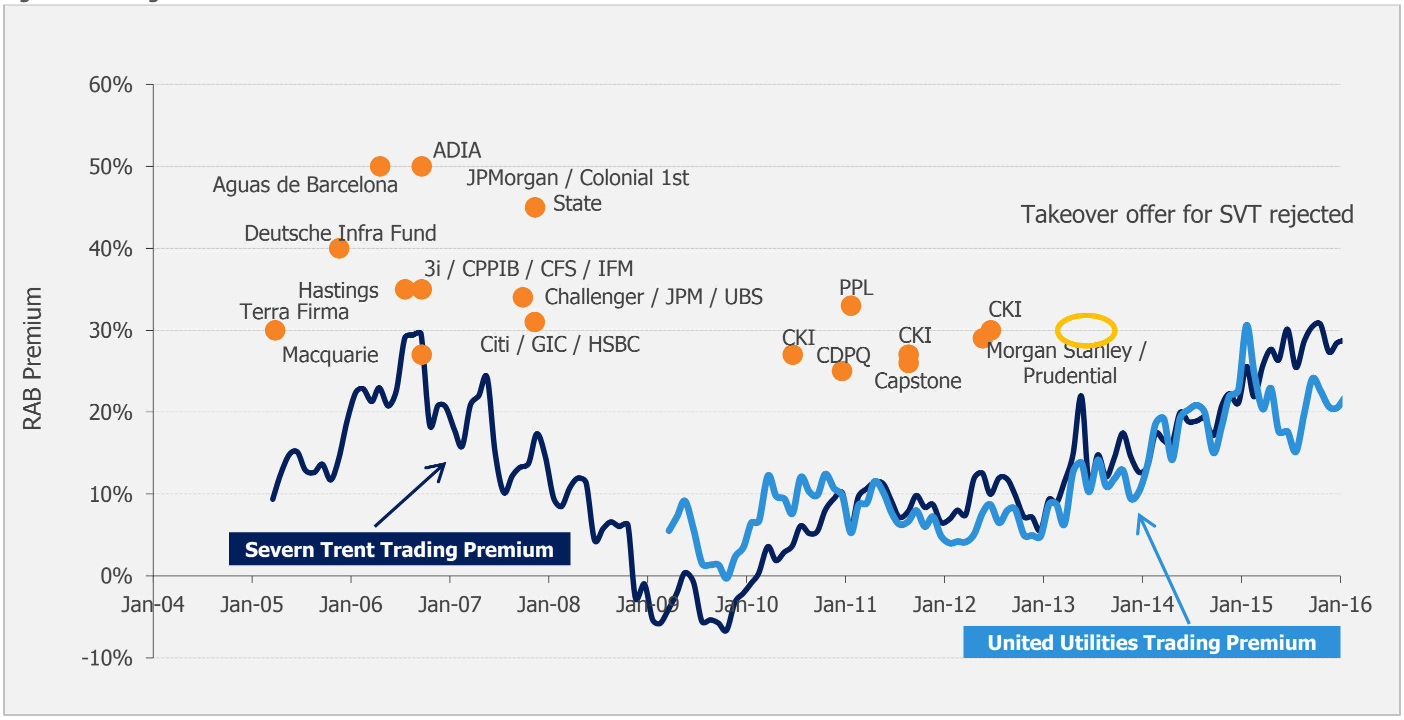
In theory, private-market infrastructure assets should be priced at discounts to their publicly-traded equivalents, given their illiquidity (i.e. the relative inability buy or sell them readily). This pricing dynamic should present an opportunity for pension plans and other long-term investors to arbitrage their long-dated investment timeframe against investors that require greater short-term liquidity, therefore allowing them to derive superior returns.

However, contrary to this notion, an imbalance in the demand and supply of private-market infrastructure assets has caused the opposite to occur in recent years. Specifically, unlisted assets have been acquired at valuation *premiums* to their publicly-traded peers. To demonstrate this, Figure 1, shows the valuations paid over the last decade in various UK water utility acquisitions using an Enterprise Value to Regulated Asset Base ('RAB' - which can be thought of as net tangible assets) multiple. Each orange dot represents the acquisition of an unlisted asset, while the continuous lines show the equivalent trading multiples of the two major regulated water utilities still trading at the end of the period in question.

The regulatory regime in the UK is highly developed and utilities are permitted to earn a set, fair return on their RAB, regardless of who owns or runs the asset. In the long run, asset owners have only very limited ability to increase returns above those allowed by the regulator, as efficiencies are passed to consumers via imposed price reductions. Consequently, the fair value of these utilities is a small premium to their RAB, which is indeed what the listed assets in the graph typically exhibit. However, the graph also clearly shows a consistent pattern – with unlisted asset transactions taking place at a 30% premium to underlying RAB. Note the rise and fall Severn Trent's share price in 2013, when news of a potential, but ultimately unforthcoming, takeover was made public.

Proponents of investing into unlisted infrastructure assert that investors in the unlisted market have longer-term investment horizons and are more rational in nature, and that the market is less volatile due to more rational supply and demand dynamics. However, a rational investor cannot justify acquiring a strictly regulated asset at a 30% premium over its RAB. Clearly, supply and demand for UK water utilities is in sharp dislocation and has been so for almost a decade; as a result, the unlisted market suffers significantly from irrational pricing.

Figure 1: UK Regulated Utilities – RAB Premiums for Transactions



Source: MFG Asset Management company data and Deutsche Bank

The Illusory Risk Reduction of Unlisted Assets

The intrinsic value of any long-dated asset (including infrastructure assets) is simply a function of its future cash flows and their associated risks. Because of the predictability of their cash flows, the intrinsic valuations of infrastructure assets tend to be very stable over time. Despite this, stock prices fluctuate above and below this intrinsic value, therefore presenting investors the opportunity to achieve superior risk-adjusted returns.

The more infrequently asset valuation takes place, the less accurate the accounting value of an asset is likely to be. As a result, less-frequently valued assets (such as unlisted infrastructure assets) present risks to certain institutions, such as defined contribution plans. For these, the liquidity mismatch created by offering members the ability to transact (by switching investment options or joining/departing the plan) more regularly than assets are valued increases the risk of such a plan's assets' values being misrepresented to investors, which can lead them to join the plan at an inflated price (or depart at an artificially low price). As Australian superannuation funds generally allow their members daily liquidity, even quarterly valuations present significant risk for members to transact at inaccurate prices.

The counter-argument often put forward is that listed investments contain "beta risk," i.e. are subject to the volatility of the broader equities market because they are listed on an exchange. The merit of this argument is rather difficult to follow. For example, in the event that an asset is 50% privately traded and 50% publicly traded, it is difficult to make the case that the publicly-traded portion of the same asset carries higher risk.

Given the above, it is rather surprising that many institutional investors deem private-market assets lower risk than their publicly-traded equivalents. In the eyes of rational investors, asset valuation frequency has no bearing on an asset's fundamental business risk; while the more frequently an asset is valued, the lower the investment risk it presents.

Other Considerations

Outside of risk and return, there are also a number of other considerations worthy of mention that institutional investors should consider:

- Management costs of private-market infrastructure against public-market alternatives and, in particular, the justification for high management fees on highly regulated assets.
- The implications of the use of illiquid assets on the management of overall asset allocation and the pressure this places on a fund to acquire private-market assets at the tail end of a significant public-market rally to maintain a proportionate weighting, potentially exacerbating the cyclicality of portfolio returns.
- Public-market allocations are likely to be more diversified than private-market allocations. Diversification is particularly important as the returns on infrastructure assets can be significantly impacted by regulatory outcomes. Highly-undesirable return asymmetry can occur when investment is concentrated among few assets and regulatory jurisdictions.
- Latent demand for private infrastructure assets may cause prices to remain inflated for a sustained period. For example, Preqin recently reported that there are over 170 unlisted infrastructure funds seeking new capital commitments totalling US$120bn. This is in on top of the US$108bn of capital already committed but not yet invested.[1]
- Public markets offer a significantly increased investment opportunity set.
- Public markets provide greater transparency, given the strict disclosure conditions imposed on listed entities.

Conclusion

MFG Asset Management's analysis suggests that appropriately diversified exposure to the infrastructure sector, when conservatively defined, may provide investors with MFG's return objective of inflation plus 5% - 6% before fees. Such a return may be expected through an allocation to either public-market or private-market infrastructure assets (and does not require infrastructure assets to be cheap to start with). However, historical data suggests the listed market offers investors higher post-fee return prospects, combined with potentially lower risk. We would expect this trend to continue given current and foreseeable market conditions.

MFG Asset Management acknowledges that there are attractions of investing directly in unlisted infrastructure assets for certain institutional investors, i.e. owning positions in those assets directly on their books rather than through the medium of a fund managed by a third party. In particular, owning a large position in an asset directly reduces agency risk (the risk that the investor will not enjoy the full benefits of the asset's cash flows). However, experience suggests that, only very large investment institutions with specialised internal infrastructure teams can expect to be successful when competing for such assets. MFG Asset Management is aware of only a relatively small number of investment institutions globally that would be adequately resourced for such an endeavour.

[1] Preqin Infrastructure Spotlight, January 2016