Deutsche Asset Management

Repositioning infrastructure portfolios in a strengthening economic environment

Recently, **Chase McWhorter,** managing director of infrastructure at Institutional Real Estate, Inc., spoke with **Jane Seto** of Deutsche Asset Management. The following is an excerpt of that conversation.

Jane Seto is managing director of Deutsche Asset Management, Infrastructure. She is also portfolio manager of the company's first pan-European infrastructure fund, as well as head of North America Infrastructure, Equity. She has more than 20 years of experience in the private infrastructure sector.

What do you see as the dynamics of the infrastructure market today?

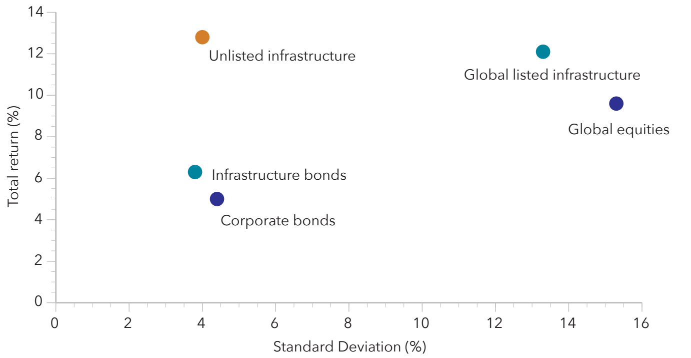
In the current financial environment, dominated by comparatively lower returns from traditional investments, long-term investors look at unlisted infrastructure as an asset class that has historically provided comparatively strong risk-adjusted returns, limited return volatility (see Exhibit 1), and portfolio diversification.[1]

Therefore, unlisted infrastructure has the potential to be a defensive asset class, at a time of rising inflation expectations and persistent global political uncertainty. Importantly, Environmental, Social and Governance (ESG) is also increasingly considered as a key factor for infrastructure investment.

In the current infrastructure market, there is a high degree of competition for large-scale, mature, brownfield infrastructure businesses, often by large institutional investors and/or sovereign wealth funds making direct investments. And as ownership-percentage restrictions prevent some of these large investors from acquiring anything in excess of a minority stake, there has been an increase in consortium-led purchases. This has also led to an increase in valuations at the larger end of the market.[2]

However, at Deutsche Asset Management, we believe that there are opportunities for our investors to acquire assets in the middle market, where valuations are still below historical long-term averages, and where a reasonable premium over government yields is achievable. Being among the first investors in infrastructure,[3] we also recognize ESG factors can impact the long-term performance of our infrastructure investment portfolios, and we have therefore been incorporating them as a core component of our investment process and in the active asset management of companies in our portfolio.

Performance comparison (9 years to September 2017, EUR)



Source: Deutsche Asset Management, Markit, Bloomberg. Infra Bonds: iBoxx Infrastructure Index, Corporate Bonds: iBoxx Non-Fin Corp Index, Global Listed Infra Equities: Dow Jones Brookfield, Global Equities: MSCI World, Unlisted Infra: MSCI Global Quarterly Infra Asset Index, October 2017. Past performance is not a guide for future results. Index performance assumes dividend reinvestment; however, these figures do not include fees, transaction costs, taxes, brokerage costs or other charges, which would reduce returns. It is not possible to invest directly in an index.

You mentioned direct infrastructure investors. They're actually your competitors, right?

Not necessarily, as direct investors typically seek to deploy in excess of $300 million to $500 million of equity for a minority stake into a single transaction.[4] Thus, they tend to focus on much larger deals. Moreover, institutional investors — who sometimes have limited resources to dedicate to the infrastructure investment process — will tend to focus on opportunities where there is a well-organized process, which generally are the most competitive auction or public tender processes.

While larger institutional investors are now investing directly, smaller asset managers who seek access to infrastructure will typically invest through a manager like Deutsche Asset Management. We believe our strategic focus on the mid-market and on more complex situations positions us to find opportunities for our investors in a less competitive landscape. For example, we look for control or joint-control positions with the objective of potentially driving value creation through active asset management and our team's operational, strategic and financial expertise, which we believe has the potential to result in further alpha generation.

What is your outlook on the U.S. infrastructure market?

We see the U.S. as a promising market. Going forward, the U.S. may have to spend roughly $3.6 trillion by 2020 to maintain its existing infrastructure, according to conservative estimates.[5] Infrastructure investment represents one of the key policy areas of the new administration to perform stimulus spending and boost economic growth. For this reason, we expect an increase in private sector involvement in infrastructure projects going forward.

Today, U.S. infrastructure opportunities exist, as do core plus/value-add energy opportunities, for investors seeking to diversify their portfolios of global investments. In recent years, transportation assets seem to be regaining momentum, demonstrated by, for example, the Indiana Toll Road sale or the Chicago Skyway project. However, the transportation sector, which represents the majority of the U.S. infrastructure investment requirement, has traditionally seen limited private sector involvement. This somewhat limits the possibility for investors targeting the U.S. to adequately diversify their portfolios across energy, transportation and concession-based assets.

The U.S. private infrastructure market is mature, and represents one of the largest globally in terms of transaction volumes. Country risk is low, and regulation is transparent and predictable, but does not always have the same track record of mature European markets, and tends to change by state.

We remain optimistic for the U.S. infrastructure market, and believe that the renewed policy focus on infrastructure will gradually offer more opportunities for investors to build diversified infrastructure portfolios, beyond the energy sector.

You mentioned that European infrastructure investment has a long track record. Could you give us more details?

Europe continues to represent the leading market globally for core/core-plus unlisted infrastructure investment strategies, both in terms of market size, portfolio diversification opportunities, market longevity, track record and secondary market liquidity. We are also positive on the macroeconomic outlook for Europe going forward.[6]

European infrastructure has the potential to match well with infrastructure investment strategies focusing on long-term income yield stability with some capital growth potential. For example, Europe provides access to numerous investment opportunities in transportation, such as airports, governed by mature and tested concessions that have historically provided long-term income return visibility.

European infrastructure regulation is relatively transparent when compared to other markets around the globe and provides stability at the time of rising global political uncertainty. Mature European countries can offer a mature investment environment, a transparent legal and regulatory framework, and a history of private infrastructure ownership.[7] In our view, the most relevant markets in Europe include the United Kingdom, Germany, France, Spain, Italy and the Nordics. Notwithstanding the short-term risks related to Brexit, the United Kingdom remains in our view a transparent regulatory framework, and a core market for infrastructure investment.

How can infrastructure benefit from the positive macroeconomic outlook you envisage?

The International Monetary Fund (IMF) recently upgraded its outlook for growth through 2018.[8] While the IMF's forecast for the U.S. remained relatively steady, the Eurozone was upgraded strongly for 2018. Growth is benefiting from higher trade, declining unemployment, rising consumer confidence and historically low interest rates.

Economic growth may present an ideal opportunity to improve infrastructure asset performance in certain sectors. For example, for transportation, a sector that we continue to view favorably, positive traffic volumes have the potential to generate stronger financial revenues, providing greater value to investors.

We believe an accelerating economic environment also represents a strong base for the implementation of active asset management initiatives to create value in an investment, capitalizing on core-plus investment strategies that provide income yield predictability, while potentially benefiting from the prospect of greater capital growth.

For example, we observe this dynamic in an asset that we recently acquired, Venice airport, that is benefiting from passenger growth, driven by the underlying economic growth. We also believe that based on a strategic approach focused on industrial expertise and active asset management, the airport may be positioned for capital appreciation potential in the future.

CORPORATE OVERVIEW

Deutsche Asset Management – Alternatives
Deutsche Asset Management's alternatives investment business has been investing in the asset class for more than 45 years. With more than 600 professionals worldwide and $91 billion in assets under management as of Sept. 30, 2017, we offer a range of strategies across the alternatives spectrum, including direct real estate and infrastructure, real estate and infrastructure securities and commodities, sustainable investments, private equity, and hedge funds.

Deutsche Asset Management
With about $840 billion of assets under management (as of Sept. 30, 2017), Deutsche Asset Management* is one of the world's leading investment management organizations. Deutsche Asset Management offers individuals and institutions traditional and alternative investments across all major asset classes.

THINGS TO NOTE

For Qualified Investors (Art. 10 Para. 3 of the Swiss Federal Collective Investment Schemes Act (CISA))/ For Professional Clients (MiFID Directive 2004/39/EC Annex II) only. For institutional investors only.

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[1]For more information on correlation coefficient pls. see Deutsche Asset Management, "Why Invest in Infrastructure?", May 2017
[2]Based on publicly available transaction information and data from various sources, including Infrastructure Journal and Infra News as of November 2017
[3]With over 20 years of experience, Deutsche Asset Management was one of the first asset managers in direct infrastructure investment
[4]Based on publicly available transaction information and data from various sources including Infrastructure Journal and Infra News as of November 2017
[5]American Society of Civil Engineers (ASCE), March 2017
[6]Based on publicly available transaction information and data from various sources including Infrastructure Journal and Infra News as of November 2017
[7]Based on Deutsche Asset Management internal infrastructure research methodology, and proprietary country ranking model for unlisted infrastructure investment, November 17, 2017
[8]IMF, World Economic Outlook, October 2017