

UBS Asset Management

High cash yield and inflation protection — back to basics in infrastructure investing



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Chase McWhorter, Institutional Real Estate, Inc.'s managing director of infrastructure, recently spoke with **Tommaso Albanese**, head of infrastructure, and **Declan O'Brien**, senior analyst, infrastructure research and strategy, of UBS Asset Management. They spoke about the current trends for infrastructure investors, in terms of both equity and debt. An excerpt of that conversation follows.

What is UBS' strategy within the infrastructure sector?

Albanese: We continue to expand our infrastructure business by bringing on new resources and expertise, offering new products, and strengthening the team with the expansion of the infrastructure research capabilities. We are currently a platform of SFr4 billion (\$4.07 billion). We have three main strategies: **global infrastructure equity**, **European infrastructure debt** and **Swiss clean energy equity**. The OECD global infrastructure equity was the first strategy for the business, established in 2006 with a maiden fund of about \$1.5 billion. It was followed by a subsequent fund in 2015, and we are now aiming to launch a third fund. We focus on essential infrastructure assets that produce high cash yield, and have inflation protection and low sensitivity to the economic cycle. In our second strategy focused on European infrastructure debt, our original fund of €570 million (\$684 million) is 94 percent invested, and in March 2018 we launched a follow-on fund. We are targeting €700 million (\$852 million) for this fund, having already raised more than 60 percent at first close. Both funds target senior secured debt with an investment-grade quality and assets that qualify as "eligible infrastructure investments" under Solvency II, which provides a capital benefit for insurance companies and regulated pension funds. The third strategy in our platform is investment in Swiss clean energy equity, in collaboration with an external specialist asset manager. We closed the first fund in 2014 for SFr400 million (\$407 million), and we launched a second fund in September 2017, which has about SFr220 million (\$223.8 million) in commitments.

Given your experience to date, what are the relative merits and drawbacks with each type of infrastructure fund?

O'Brien: Many institutional investors invest in both infrastructure debt and equity; however, the rationale for investing in either equity or debt may differ. For example, our debt strategy is focused on high-quality, stable infrastructure assets, and we see this as being ideal for liability-matching investors or those seeking a low-risk investment. The European strategy specifically targets Solvency II eligible infrastructure investments, which are very capi-

tal efficient for European insurers and regulated pension schemes. On the other hand, infrastructure equity offers higher yield than a senior debt strategy, and so we see that as being particularly attractive for pension schemes and insurers seeking yield pickup, diversification from listed equities and some inflation protection.

With the current level of increased competition characterized by high asset valuation, are managers willing to take on more risk to find attractive returns?

Albanese: Asset valuation at the moment is historically high, but not if you compare it with the other asset classes available. Valuations are tied to the current pace of capital deployment. If there is a slowdown in the level of new flows or interest rates start to increase, this should be good for deployment, providing additional interesting opportunities. However, for managers with a strategy based on capital growth — such as value-added or opportunistic investing — the sector could come under pressure. We have indeed been seeing an upwind shift in the risk curve, with managers taking more risk for higher returns — whereas we have remained focused on traditional core infrastructure assets. For us, that is the reason to go into the sector — stable cash flows and solid high cash yield. Ultimately, when you go into value-added or opportunistic investing, most of the return is coming from expected capital appreciation, which you would capture when you sell it, and that could be 10, 15 years away. We focus on the traditional infrastructure investment and the high cash yield that is generated year after year, after year, after year.

O'Brien: As with most private asset classes, valuations are high by historical standards, and this is driven by capital flows into private assets as a result of quantitative easing and a low-yield environment. But there is still a significant pickup from other available assets, such as bonds. Specific to infrastructure, new and existing players in the market are exploring sectors not traditionally seen as core infrastructure, so the envelope is widening in this context, with a focus not just on income-producing assets, but also strategies to grow the business and add value. But what our strategy endorses in the equity space is the traditional.

What do you mean by "traditional"?

O'Brien: Stable cash flows from essential assets with low correlation to vanilla asset classes and inflation protection. We don't really subscribe to the nomenclature of "core, core plus, value add." By focusing on the traditional, we are targeting the features of the asset class that initially attracted investors to it. Additionally, by targeting a high cash yield, we are providing protection to investors if flows into the asset class were to slow, i.e., the bulk of your return is generated from income, meaning that you are not overly reliant on the exit process to generate your target returns.

How is regulation impacting how investors view the asset's attractiveness?

Albanese: Infrastructure as a sector has always been seen as a proxy for the public sector, being regulated, concession-based, with some government sponsorship. Regulation is particularly relevant now for infrastructure debt, which has been fast growing as the related institutional market continues to develop. The change in banking regulation with the introduction of the Basel III, the international banking regulations, has created an opportunity for institutional investors to get more involved as banks have reduced their ability to lend due to regulatory capital constraints. This has created quite a shift in the market, with the public sector still constrained by budget deficits, creating a need for new sources of capital. Another cause of this shift is the introduction of the Solvency II Directive for insurance companies. In Europe, it put into place some new guidelines for solvency capital requirements for both debt and equity, but it also recognized the nature of the infrastructure sector as a lower risk and, therefore, with lower capital requirements. Other countries have been following this example since then. Korea and Japan both put into place a similar regulation. There is more focus on risk-adjusted returns, and infrastructure — being lower risk — certainly benefits.

O'Brien: Regulated assets are intrinsically monopolistic-type assets with a lot of government oversight. Increasingly, we are seeing, especially in Europe, a rise of populism, which turns the focus on affordability, and infrastructure investing is becoming more politicized. Regulators are coming under pressure to demonstrate that they are not allowing private operators of these essential social assets to generate excess profits. With essential assets like utilities and transportation, it is very easy to point at things that are not working as well as consumers would like; however, the private sector has not been particularly good at showing how it has been adding value and probably needs to do more to show the benefit of private ownership.

What other key concerns you are hearing from investors in the current economic environment?

O'Brien: The question I get asked the most relates to the impact of interest rates. In the most recent Preqin investor survey, investment consultants rated interest rate risk as No. 1 amongst their investment concerns. That was a change from previous years, where it had been valuations. We decided to undertake a specific analysis to understand what the impact of interest rates would be on infrastructure, the results of which we published in a white paper called *Infrastructure and the Economy*. We found that the tapering of quantitative easing and the rise of interest rates across the world are being driven by both solid economic growth and increasing inflation. We see both of those — strong GDP growth and increasing inflation — as being broadly positive for the infrastructure sector, and we believe that their positive impact offsets the negative impact that you could have from a modest increase in interest rates. Of course, a big caveat here is that the impact on each individual asset will depend on its capital structure. Also, because we have had such a prolonged period of low interest rates, infrastructure owners have been busy refinancing their assets with long-term debt

to lock in those very low interest rates, which can mitigate the impact of rising interest rates on specific assets. Another insight we gained from our analysis was that, when the economy is booming, most listed equities have outperformed in the past. Infrastructure is not designed to be a boom-and-bust asset class. It is designed to provide stable cash flows, resilient, monopolistic services, so you wouldn't expect it to outperform the market in a boom environment, but when GDP is below average, infrastructure should outperform equities. So depending on what the economic environment is, the relative attractiveness of the asset class can change. According to the Preqin survey, 90 percent of investors expect to deploy at least the same capital over the next 12 months, so clearly the sentiment for the sector is still very positive, and 93 percent of those investors surveyed felt infrastructure had met or exceeded their expectations, so the sector has been performing well.

We've also noticed that investors are becoming even more focused on Environmental, Social and Governance (ESG) issues, which are a key focus in our business. We have a strong track record in ESG, with Fund I and Fund II ranking No. 1 and No. 2, respectively, in the GRESB 2017 survey. Similarly, our second debt fund, IDP2, worked with a leading environmental consultant to create an ESG scorecard for infrastructure debt, as no tool was available in the market to evaluate investments in a systematic way for ESG.

Specifically, where do you see the best opportunities in infrastructure?

O'Brien: In terms of debt, the focus for our European strategy, at least, is in the mid-market. We believe this can provide good risk-adjusted returns. When you look at the European debt market in 2016, around 75 percent of the transactions in the market were less than €250 million. As the banks retreat, this leaves opportunities for investors like us, who can source transactions directly and undertake hands-on structuring of investments. We believe that this is how you capture the best risk-adjusted returns in the current market.

Albanese: In terms of equity, there has been a broadening of the infrastructure definition. Today a manager is able to find assets offering attractive risk-adjusted returns in a variety of target sectors and geographies. We believe that at the moment unregulated utilities and transport assets offer attractive opportunities, particularly in Europe. In the United States, we think that the continued evolution of energy fuel toward more renewable and cleaner sources will continue to be an interesting trend and opportunity. And alternative fuels, including geothermal, biomass, landfill gas, will also be important. The global themes of energy transition and digitalization will create future opportunities for equity in sectors such as energy storage and fiber.

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