SPECIAL REPORT INFRASTRUCTURE

The quest for alternative investments

Poor performance from traditional markets has prompted investors to seek alternatives. But do they understand the risks involved?

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Lacklustre performances from traditional markets have pushed investors toward alternative investments in the pursuit of returns. New (and old) money has been shifting to frontier markets like Russia and new asset classes like commodities. But do investors really understand the risks in these investments and will the potential returns compensate for higher volatility over the long term?

Listed infrastructure is an alternative asset class that should appeal to a broad range of investors. Infrastructure assets are simple to understand. If you pay for electricity, gas and water, drive on a toll road or fly from an airport, you already understand the benefits of investing in infrastructure:

- Barriers to entry: how many years have you paid the same electricity supplier?
- Pricing power: are you paying higher tolls than 10 years ago?
- Predictable cash flows: when was the last time you did not pay the gas bill?
- Sustainable growth: is the airport busier than 10 years ago?

Think of an investment in a listed infrastructure fund as a natural hedge to daily frustrations.

Competitive returns, lower volatility

Listed infrastructure has delivered good risk-adjusted returns over the last 10 years. Property has outperformed over this period, though the recent collapse of the sector may point to a review of future return expectations. Infrastructure has delivered comparable returns to current 'hot' sectors of emerging markets and energy, with half the volatility.

The significant market volatility which began in July 2007 has been the ultimate test of the defensiveness of listed infrastructure. While there have been pockets of disappointment, on the whole the sector has delivered earnings results at or above market expectations, provided positive outlook comments, announced a number of share buybacks and successfully refinanced debt at a marginally higher cost. While market volatility remains high, the score board for listed infrastructure is displaying positive returns with outperformance of most markets by 10%-15%.

It is important to note this relative performance is not a one-off. Over the last 10 years there have been 70 months of 'up' markets and 50 months of 'down' markets for global equities. In relative terms, infrastructure has delivered 80% of the 'up' but only 40% of the 'down', highlighting the sustainable growth of the sector over the long term.

History lessons

Historical risk/return analysis is useful for placing infrastructure in context with alternative asset classes, but investors should take a forward view on the prospects for returns.

An analysis of bottom-up yield and growth expectations by sector supports forward returns of 10%-12% per annum for a well-selected infrastructure portfolio. This return includes prospective dividend yields of 3%-4% per annum and assumes constant risk factors. However, total returns vary by sector, reflecting underlying growth expectations.

Utilities should deliver total returns of 8%-12%, the top of the range reflecting companies with strong organic growth options. Examples include Spanish regulated transmission businesses Enagas and Red Electrica.

Energy infrastructure should deliver total returns of 10%-14%, the top of the range reflecting new pipeline build. Examples include Pembina Pipeline and Enbridge Energy Partners, where regulated pipelines are connecting Canadian oil supplies with strong US demand.

Transport infrastructure should deliver total returns of 12%-16%, the top of the range reflecting the impact of globalisation on airports and ports. Examples include Vienna Airport and Port of Hamburg, where growth in Eastern European markets is stimulating demand.

Comparing current yield and growth expectations is valuable but it is only half the equation. Infrastructure valuations could be impacted by changes in regulation, interest rates, capacity constraints, environmental costs or capital flows.

The emerging nature of the infrastructure asset class also means measures of risk may change over time. For example, industrial companies that dispose of non-core assets to focus on infrastructure will reduce risk while toll roads that add layers of gearing to improve equity returns will add risk.

When investing in global listed infrastructure companies it is important to evaluate asset risk, financing risk and valuation risk.

Asset risk refers to the quality of the underlying infrastructure assets. As an emerging asset class, investors need to be careful to screen for asset quality as broad sector definitions capture everything from shipping companies to merchant power generators to commodity traders. Investors should focus on four characteristics to define infrastructure – high barriers to entry, pricing power, sustainable growth and predictable cash flows.

The essential nature of infrastructure assets means regulatory and political risks will be an important driver of asset value. Over the long term, companies that work with regulators, governments and consumers should be able to reward shareholders. A diversified portfolio focused on developed markets will also serve to mitigate specific regulatory or political risks.

Capital structure

Financial risk refers to the capital structure of the company. As should be expected, low-risk assets tend to attract higher levels of financial leverage to optimise returns to equity holders. It is important to differentiate different levels of debt within infrastructure companies. The recent credit crises have seen the more highly financial leveraged infrastructure companies suffer relative to less leveraged plays.

Valuation risk refers to the current premium investors are demanding as compensation for asset, financial and other risks. Investing in listed infrastructure carries the risk of what level of valuation multiple you pay for different companies. Using EV/EBITDA multiple as a proxy for valuation risk, while communications infrastructure may have a low level of asset risk, listed companies carry a high level of valuation risk given the aggressive earnings multiples these stocks trade on.

Global listed infrastructure has performed very strongly in a falling global equities market over the past nine months. This performance is underpinned by the four key criteria of infrastructure companies: high barriers to entry, pricing power, sustainable growth and predictable cash flows.

Historically, global listed infrastructure has delivered attractive risk-adjusted returns. With the need for new infrastructure increasing dramatically and the government's continuing inability to finance these needs, this sector will continue to deliver investors robust growth with low risks.

KEYPOINTS

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- Historically, global listed infrastructure has delivered very attractive risk-adjusted returns.