Rethinking Infrastructure

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In the early 2000s, I oversaw the establishment of the first private infrastructure fund in Canada, a process that included defining infrastructure as an investment opportunity and educating the market on the merits of these 'boring to barely interesting' assets.

Where infrastructure was once the wallflower of the alternative investment space, it now plays a starring role in an increasing number of institutional portfolios. According to Preqin, in 2014 the average current allocation of institutional investors to infrastructure increased to 4.3 per cent from 3.5 per cent in 2011, while the average target allocation increased to 5.7 per cent from 4.9 per cent over this period. And two-thirds of investors are planning to increase their infrastructure allocation over the longer term, delineating infrastructure as a distinct subset of the private capital sector.[1]

Growing Appetite

This growing investor appetite for infrastructure reflects overall demand for real alternatives that are more resilient to economic cycles, have lower correlations with traditional asset classes, provide some inflation protection, and deliver current yield. Specifically, the infrastructure asset class, while relatively young, has generally demonstrated a stable return profile both pre- and post-financial crisis, with a critical mass of evidence suggesting that adding unlisted infrastructure to a portfolio typically delivers diversification benefits, improves return per unit of risk, and enhances overall efficiency.

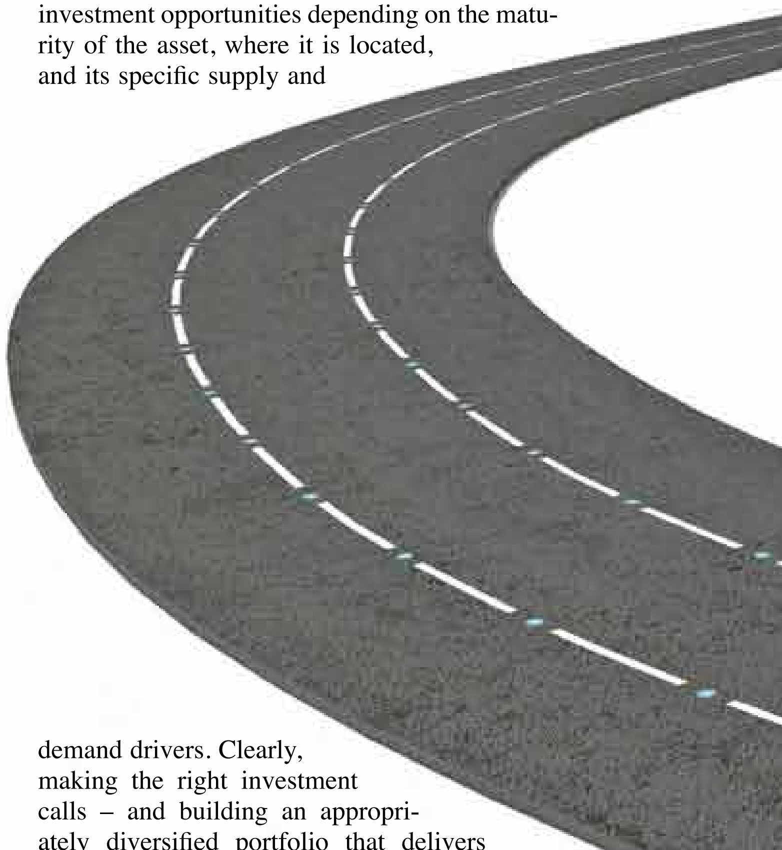
At the same time, aging critical infrastructure in North America and elsewhere is fuelling enormous demand for capital to maintain and modernize infrastructure as countries grapple with the myriad challenges arising from increasing urbanization and globalization, demographic growth, and climate change imperatives, among others. It is estimated that about US$5 trillion in global infrastructure investment is required per year to 2030 in various sectors.[2]

Lag Growth

Institutions are embracing infrastructure as a core component of their asset mix and the need for infrastructure investment across the spectrum – in power, transportation, water, telecommunications, and more – has never been greater. Yet investors' deployment of capital continues to lag growth in allocations. This dichotomy highlights three main obstacles – both perceived and real – that investors are contending with in this increasingly high-traffic market.

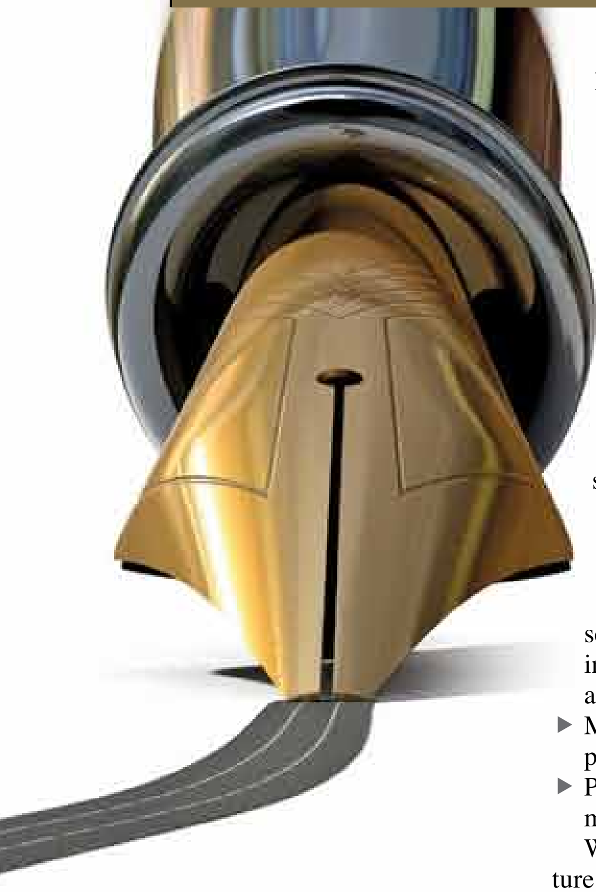
First, robust capital inflows to the sector overall are driving heightened competition for certain assets, often resulting in aggressive pricing and higher valuations, particularly for operating assets, and leaving investors concerned about whether there are enough attractive investment opportunities available. I believe the real challenge for investors is less the competitive landscape, as there will always be examples of mispriced assets, and more about staying disciplined and focused on their own objectives, risk tolerances, and areas of expertise. In my view, there are more quality infrastructure investment opportunities available today than ever before, particularly in the North American middle market (defined as assets having an enterprise value ranging from $100 million up to $1 billion) where we are seeing considerably less competition than in the market for large-scale assets.

Second, the infrastructure universe is highly complex. While infrastructure is distinct from other asset classes, it is itself a diverse category with both core and non-core assets, the former consisting of assets such as mature, regulated utilities and the latter typically referring to more volume-dependent infrastructure such as sea ports or railways. The risk/return spectrum between these categories, and sometimes within a single category, varies dramatically. Even infrastructure assets with the same physical characteristics can represent very different investment opportunities depending on the maturity of the asset, where it is located, and its specific supply and



demand drivers. Clearly, making the right investment calls – and building an appropriately diversified portfolio that delivers consistent returns – necessitates a deep understanding of these complexities and inherent risks.

Finally, there is a clear moral and social overlay to infrastructure investment. The tangible socio-economic footprint of an infrastructure asset, by virtue of the essential services it



delivers, makes political and regulatory risks especially acute, and, without the right risk mitigation mechanisms and experience, a potential minefield. And unanticipated changes can radically alter an asset's investment profile as we have recently seen in the UK water sector.

Path To Market

These obstacles, which are not insurmountable, underline the value of expertise and the importance of having – and sticking to – clear objectives and established risk tolerances.

While more institutions and pension funds are investing directly, it is an undertaking fraught with challenges related to scale, capacity, and transactional skill. Finding investment opportunities with the right structure and setting, and then managing them properly to maximize returns requires deep market knowledge and effective risk management. Sophisticated operational know-how is also critical because, in my experience, operational improvements can generate up to approximately 100 to 300 basis points of additional return on investment.

For these reasons, investing in unlisted funds with a seasoned manager or as a co-investor alongside a fund typically provides access to the diversity, quality, and returns investors are seeking, but at a lower risk than flying solo. When evaluating prospective partners, investors should seek:

- A clear strategy and flexible mandate that enables a fund to capitalize on relative value plays in select jurisdictions and within defined infrastructure categories to generate an attractive risk-adjusted return
- Meaningful alignment of the fund's principals with investors
- Proven deal origination and asset management capabilities

While the megadeals tend to capture most of the headlines, I believe the middle market infrastructure space offers an extremely compelling value proposition. Transactions in this niche are often more complex, such as separating an asset from a larger company as InstarAGF and its equity partners did in January 2015 with the acquisition of the passenger terminal at Billy Bishop Toronto City Airport from Porter Aviation Holdings Inc. Middle-market transactions also tend to be more commonly available through existing relationships and partnerships, thereby allowing for more flexibility around timing and structuring, positioning you to successfully compete on factors other than price. My experience is that the middle market offers the opportunity to achieve returns up to 100 to 150 basis points higher than in the broader infrastructure market in the same sector and jurisdiction, an observation that is borne out in industry data. According to Preqin, infrastructure funds with less than US$1 billion in total capital commitments have often generated stronger returns than funds with US$1 billion or more in total capital, with a median net IRR of approximately 9.8 per cent and 7.5 per cent, respectively.[3]

Staggering Need

The need for infrastructure investment is staggering, with trillions of dollars of investment required globally over the next two decades. It is inevitable that a wealth of investment opportunities will come to market in the years ahead and that private investors will play a pivotal role in delivering the new and improved infrastructure that our economies and quality of life depend on.

Institutional investors are drawn to the infrastructure asset class for its attractive return attributes and power to build wealth for their millions of beneficiaries. But it is also worth remembering that a dollar invested in modernizing or building infrastructure directly affects productivity, job growth, and socioeconomic conditions. In Canada, every one per cent increase in infrastructure spending is estimated to have an economic multiplier effect of up to 1.6 times.[4] And the legacy of infrastructure renewal – greener electricity, cleaner water, and better public transportation – reverberates for generations.

There's certainly nothing boring about that.

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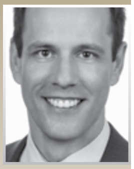

1. 2015 Preqin Global Infrastructure Report
2. World Economic Forum, 2013
3. Preqin, 2014. Data includes all infrastructure funds in Preqin's database with appropriate data on internal rate of return dating back to 1992
4. Canada's Economic Action Plan: A Seventh Report to Canadians, Department of Finance Canada, January 2011.