IFM Investors



Why invest in unlisted infrastructure?

February 2024






Well-managed unlisted infrastructure assets can provide long-term institutional investors with a range of potential benefits, including portfolio diversification, earnings stability, and inflation protection. In recent decades, the recognition of unlisted infrastructure's distinct characteristics has elevated it from being bundled with other alternative investments, such as real estate and private equity, to standing confidently on its own.

This paradigm shift has seen unlisted infrastructure become a cornerstone in the diversified portfolios of many of the world's most sophisticated institutional investors, with allocations to unlisted infrastructure continuing to increase globally.[1]

[1] Croce, B. (2023, June 1). Major pension funds are steering big dollars to infrastructure. Pensions & Investments. https://www.pionline.com/infrastructure/major-pension-funds-are-steering-big-dollars-infrastructure

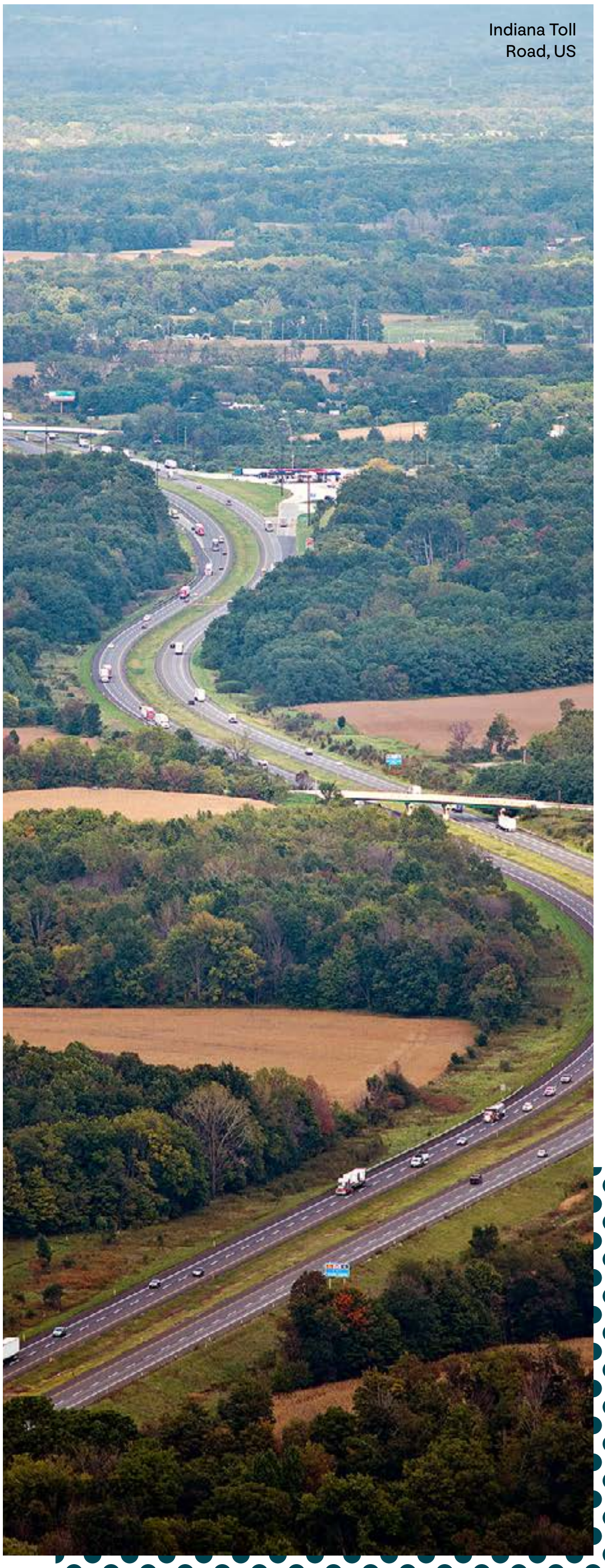
What is infrastructure?

As an asset class infrastructure encompasses essential utilities, services and facilities that underpin the economic functioning of the regions in which they operate. To help determine what constitutes an infrastructure investment, we like to point to the below set of characteristics that clearly distinguish it from other asset classes:

- **Strong market positions and high barriers to entry**
- **Long investment horizons (e.g. concessions of 25 years, leases of 99 years)**
- **Relatively stable and predictable revenue streams**
- **Inflation protection and inelastic demand for services (giving pricing power)**

Examples of infrastructure assets include transportation systems such as airports, toll roads, seaports and freight hubs; utilities such as sewerage, energy distribution networks, power generation, water and communication networks; digital infrastructure such as data centres; and social infrastructure such as healthcare, defence and judicial buildings, and education services.

The distinctive characteristics and benefits of infrastructure investments reflect the fact that they are essential, long-standing assets with stable, revenue-generating capabilities.


Indiana Toll Road, US

How is unlisted infrastructure different from other asset classes?

While unlisted infrastructure was historically combined with other alternative assets, such as real estate and private equity, several characteristics warrant its inclusion as a standalone asset class in a diversified portfolio.

1. Long holding periods

Unlisted infrastructure assets are often held, managed, and improved over decades, greatly enhancing their potential for growth and weathering short-term economic downturns. The ability to consistently deploy and reinvest capital in an infrastructure asset not only maximises returns but also allows investors to take advantage of market opportunities. Additionally, holding onto assets for prolonged durations minimises trading and reinvestment costs, while also capitalising on the compounding effect for returns over time.

At IFM Investors, we believe pension funds are well-placed to maximise their investments in asset classes like unlisted infrastructure, as pension members' long investment horizons are well-matched with infrastructure assets' long investment life cycles.

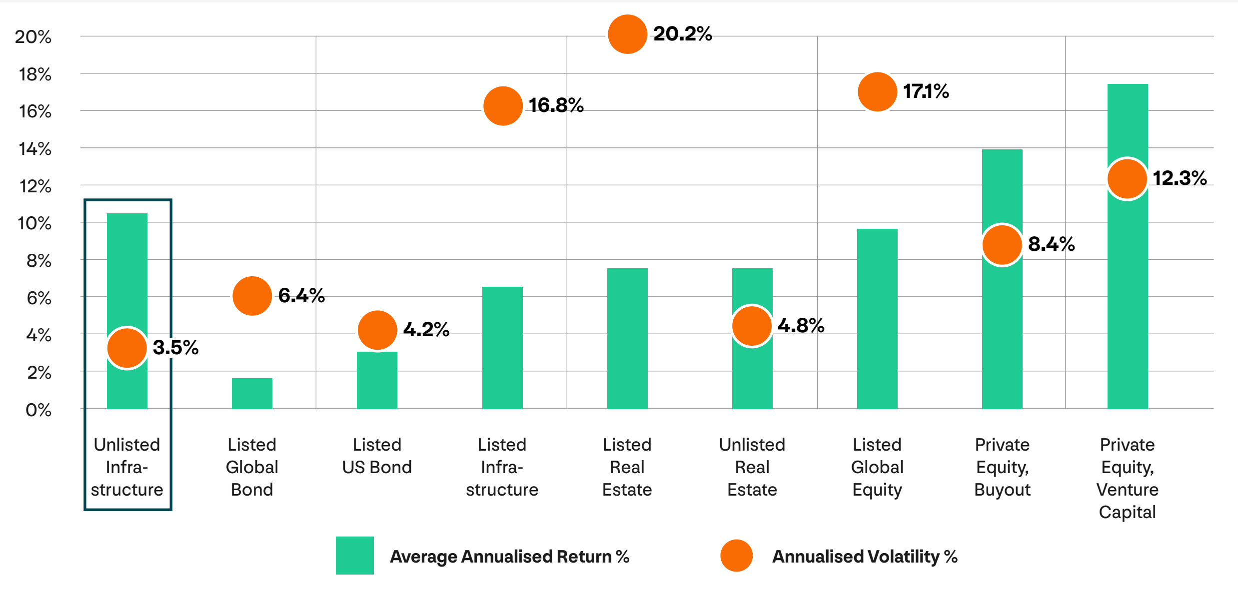
2. Low volatility of returns

Historically, unlisted infrastructure assets have demonstrated lower volatility in returns than other growth asset classes (see Figure 1). Many infrastructure assets, such as airports, toll roads,

FIGURE 1

AVERAGE RETURN AGAINST ANNUALISED VOLATILITY

31 March 2009 to 31 March 2023



Sources: OECD, MSCI, Bloomberg, Burgiss Universe Analytics.

Asset class performance reflects the change in the returns of the following indices: Unlisted Infrastructure – MSCI Global Quarterly Private Infrastructure Asset Index (Unfrozen); Listed Infrastructure – S&P Global Infrastructure Index; Unlisted Real Estate: NCREIF Property Index; Listed Real Estate – FTSE EPRA/NAREIT Developed Index; Listed Global Equity – MSCI World Index; Listed Global Bond – Bloomberg Barclays Global Aggregate Index; Listed US bond – Bloomberg Barclays US Aggregate Index; Private Equity, Buyout - Burgiss Manager Universe, All Buyout Funds, Developed Markets; Private Equity, Venture - Burgiss Manager Universe, All Venture Capital Funds, Developed Markets and utilities, serve essential needs and have inelastic demand. The demand for these services is relatively stable; for example, consumers continue to use water, electricity, and gas even in times of economic weakness. The inelastic demand helps maintain a steady cash flow, regardless of economic cycles. In addition, many infrastructure projects are governed by regulatory frameworks. Regulatory authorities often work to help ensure a fair return on investment for infrastructure providers, contributing to a more stable financial environment and lower volatility.

3. Inflation protection
Infrastructure assets often exhibit positive correlations with inflation through various mechanisms, including direct inflation-linked rate setting, regulated real returns, and the ability to pass through cost increases to customers. Such arrangements are common amongst regulated utilities, toll roads, and seaports. These features help mitigate the impact of inflation on the real value of returns, providing a degree of insulation against economic uncertainties.

4. Provide essential services with monopolistic positions
Infrastructure predominately operates in sectors such as essential transportation or utilities where there are limited competitors or a monopoly position. The lack of intense competition can contribute to more stable pricing structures and reduced sensitivity to market dynamics. Further, infrastructure assets play a pivotal role in delivering essential services to communities. Hence, governments and regulatory bodies have a vested interest in ensuring a fair return on investment for infrastructure providers, contributing to more stable and predictable income streams.

5. Diversification at multiple levels
Infrastructure investments provide a high level of diversification at both the asset class and underlying asset levels. Infrastructure funds are strategically invested across a range of sectors, such as airports, utilities and digital infrastructure, and derive their returns from diverse revenue sources. For example, apart from generating aeronautical revenue, airports also earn income from parking, retail, dining and selling advertising space inside and outside terminals.

Baltic Hub DCT
Gdansk Port, Poland

CASE STUDY

Sydney Airport, Australia

Sydney Airport:

Demonstrating distinct and attractive investment characteristics

On 9 March 2022, IFM, together with a consortium of investors, acquired Sydney Airport in a take-private deal valuing Sydney Airport ("SYD") at an equity value of A$24 billion. SYD is one of Australia's most important infrastructure assets, being a key international gateway into Australia and the largest Australian airport by passengers. Utilising the above framework, SYD provides investors with the following benefits:

1. Long holding period – As a dedicated long-term investor, IFM strategically targets assets for significant holding periods, allowing for the reinvestment of capital into a well-understood asset. SYD exemplifies this characteristic with a concession lasting until 2097, aligning with IFM's commitment to enduring investments.

2. Established strong record and strong fundamentals – Historically, SYD has demonstrated a long history of passenger growth (1992-2022 pax CAGR: 2.2%)* due to its diversified traffic profile of both domestic and international travellers, helping it achieve relatively low volatility of returns.

Notably, in 2019 Sydney to Melbourne was the second busiest route in the world, accounting for 33% of SYD's total domestic passenger volume. This track record contributes to SYD's ability to maintain relatively low volatility in returns.

3. Diversification of revenues - SYD has a well-diversified mix of aeronautical (50.0% of CY22 revenues, excl. security revenue) and commercial revenues, which are further segmented into retail (17.3% of CY22 revenues), parking and ground transportation (12.6% of CY22 revenues), and property and car rental (20.1% of CY22 revenues). Additionally, SYD has higher per passenger spend rates than comparable Australian airports due to premium offering and higher yielding passenger mix.

By embodying these characteristics, Sydney Airport underscores the attractiveness and distinct advantages associated with infrastructure investments, which aligns with IFM's strategic approach to long-term, resilient assets.

* 2020 - 2022 passenger numbers were adversely impacted by the COVID-19 pandemic and associated travel restrictions. The 1989-2019 pax CAGR was 5.0%, prior to COVID-19 impacts.

How does unlisted infrastructure compare to real estate?

Real estate investments include commercial assets such as office buildings, warehouses and shopping centres, multi-family residential buildings, and industrial property. Real estate assets generate returns from increases in property values (particularly through development) and rents. While both unlisted infrastructure and real estate investments offer the potential for long-term growth and income generation, there are some distinct differences between the two.

Monopolistic positions with defensive characteristics
Infrastructure assets providing essential services, such as airports, seaports and utilities, exhibit monopolistic characteristics, generating predictable cashflows that inherently act as defensive assets. Infrastructure is a highly capital-intensive industry compared to real estate investments. High barriers to entry and diverse revenue streams, as illustrated by the case study of Sydney Airport on page 6, further fortify their resilience against market disruptions, setting them apart from the cyclical nature of the real estate market. One of the most distinctive characteristics of infrastructure assets which sets them apart from real estate investments is that infrastructure assets benefit from scarcity - they are much more finite in their availability than properties. For example, for every toll road that is available as an investment, there would be a large, indefinite number of commercial properties available.

Real estate investments have a higher substitution risk exposure than infrastructure assets due to factors like property vacancies, maintenance and refurbishment needs to retain and attract tenants, and market fluctuations. Recent events, such as the COVID-19 pandemic, highlighted the resilience of infrastructure assets. Both infrastructure and real estate assets faced challenges during the pandemic due to travel restrictions and work from home mandates. However, infrastructure assets experienced more robust cashflows and a quicker recovery than real estate assets, as they deliver essential services and are, by nature, critical components of a functioning economy.

Over the past year, we have seen airports continue to rebound, driven by the widespread return of travellers, with airport ticket sales trending close to 2019 pre-pandemic levels. Similarly, toll roads continue to demonstrate steady performance, with heavy and light vehicle traffic performing well, underpinned by increasing work-related commutes following the lift of travel restrictions. The same can't be said for commercial offices (about 20% of real estate), which are facing significant headwinds from the pandemic-induced slump in office occupancy rates, with some estimating that occupancy rates may not return to peak until 2040.[2]

A 'natural' inflation hedge
Infrastructure assets typically benefit from both price and volume growth, often incorporating mechanisms such as inflation-linked rate adjustments and regulated real returns. Toll road pricing, for instance, explicitly links to inflation through regulation, concession agreements or contracts, providing a natural hedge against the adverse effects of rising interest rates.

Real estate investments may lack such inherent hedges, being more sensitive to inflationary pressure. Moreover, the costs of servicing loans and building maintenance may not be easily passed on to customers under existing contracts, further underscoring the vulnerabilities inherent in real estate investment.

Diversification at the sector and revenue source levels
While real estate investments offer diversification within the broader asset class, unlisted infrastructure investments provide a distinct level of diversification at both the sector and revenue source levels. Infrastructure funds often invest across various sectors, including transportation, utilities, and communication, diversifying risk beyond the geographical or property-type constraints associated with real estate portfolios. This multi-dimensional diversification enhances resilience and risk mitigation within the investment portfolio.

Over the past year, we have seen airports continue to rebound, driven by the widespread return of travellers, with airport ticket sales trending close to 2019 pre-pandemic levels.

[2] US Commercial Property Update 22 June 2023 – Capital Economics https://www.capitaleconomics.com/publications/us-commercial-property-update/office-values-unlikely-regain-their-peaks-even-2040

How does unlisted infrastructure compare to private equity?

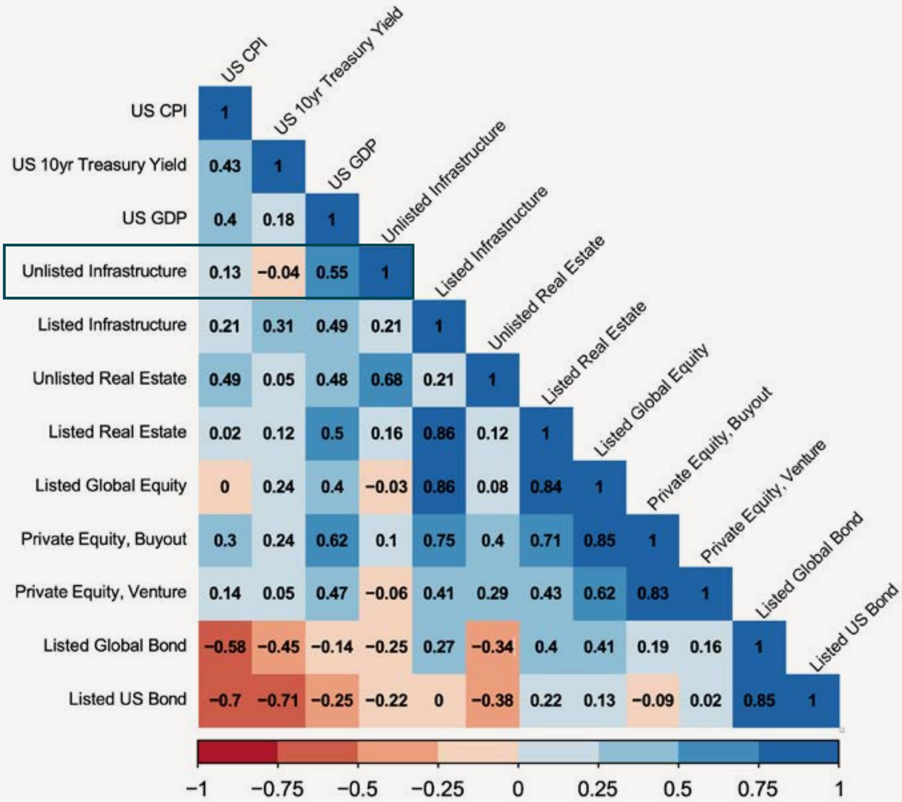
Private equity and unlisted infrastructure equity both invest in underlying equity positions. However, they acquire different types of businesses. Unlisted infrastructure funds typically invest in essential utilities, services or facilities that form the bedrock of a region's economic functionality. In contrast, private equity typically invests in smaller and riskier businesses that face significant competition.

Private equity includes buyout funds, targeting private or public companies, and venture capital funds, which fund greenfield businesses with inherently lower chances of survival. The overarching goal in both private equity categories is to increase the intrinsic value of a company within a short period of time and sell the business a few years afterwards (generally, 3-5 years, although holding periods can be shorter or longer, reaching a three-year average holding time of 5.4 years in 2019)[3] for a significant return on their investment. Like listed equity investing, private equity funds usually invest in companies across the listed company sectors, with many funds focusing on one sector (e.g. technology or energy private equity funds).

Figures 1 and 2 reflect some key differences in risk and return profiles, as well as correlation, between unlisted infrastructure and private equity assets.

FIGURE 2

CORRELATION OF INFRASTRUCTURE WITH REAL ESTATE, PRIVATE EQUITY, AND OTHER INVESTMENTS/ ECONOMIC FACTORS



Sources: OECD, MSCI, Bloomberg, Burgiss Universe Analytics.

Correlation analysis is based on rolling one-year data, calculated on a quarterly basis for the periods from 1 April 2008 through 31 March 2023. US CPI (inflation) refers to the change in Consumer Price Index for All Urban Consumers. U.S. GDP refers to the change in Real Gross Domestic Product and US 10yr Treasury Yield refers to the change in 10-Year US Treasury Yield.
Asset class performance reflects the change in the returns of the following indices: Unlisted Infrastructure – MSCI Global Quarterly Private Infrastructure Asset Index (Unfrozen); Listed Infrastructure – S&P Global Infrastructure Index; Unlisted Real Estate: NCREIF Property Index; Listed Real Estate – FTSE EPRA/NAREIT Developed Index; Listed Global Equity – MSCI World Index; Listed Global Bond – Bloomberg Barclays Global Aggregate Index; Listed US bond – Bloomberg Barclays US Aggregate Index; Private Equity, Buyout - Burgiss Manager Universe, All Buyout Funds, Developed Markets; Private Equity, Venture - Burgiss Manager Universe, All Venture Capital Funds, Developed Markets.

[3] Private equity holding periods reach all-time high in 2020 - Private Equity News (privateequitywire.co.uk)

Notably, private equity funds, both buyout and venture capital funds, offer fewer diversification benefits and can deliver lower risk-adjusted returns than unlisted infrastructure assets.

Inherent diversification benefits

Broadly speaking, private equity's performance aligns with certain limitations seen in real estate investments. Private equity's performance is highly correlated with both public markets and, more specifically, their listed sector equivalents. Essentially, private equity acts as a leveraged version of listed equity, sharing similar performance and beta characteristics. In contrast, unlisted infrastructure assets are less sensitive to GDP shocks due to their contracted revenues and monopolistic traits that help ensure resilient demand.

Infrastructure's inherent diversification benefits stem from its ability to weather GDP contractions, a resilience not shared by private equity funds. The barriers to entry and demand elasticity of infrastructure assets contribute to this distinction, positioning infrastructure assets as less susceptible to economic downturns.

Lower leverage profile

Unlisted infrastructure's resilience is further supported by its traditionally lower leverage levels. Coupled with a buy-and-hold approach, this allows for prudent hedging strategies with extended maturities, offering protection against interest rate volatility. In contrast, private equity investors often employ increased leverage to maximise returns over a considerably shorter investment horizon, exposing them to heightened vulnerability amid interest rate fluctuations.

Lower volatility of returns

While private equity funds may realise robust returns, the sector is marked by significant volatility, especially in the early stages of a fund's life. Unlisted infrastructure's lower volatility is a notable contrast, which does not compromise on expected returns. As depicted in Figure 1, unlisted infrastructure exhibits the lowest volatility among various asset classes, surpassing even Listed US Bonds. This underscores the potential of unlisted infrastructure assets to deliver stability without sacrificing returns.

Anglian Water, UK

Conclusion

Despite the historic categorisation of unlisted infrastructure alongside other less liquid asset classes, such as real estate and private equity within the alternatives investments category, these three asset classes have quite different attributes. With predictable cash flows, defensive characteristics, inherent hedges against inflation, and multi-dimensional diversification, unlisted infrastructure investments have distinct potential benefits for investors seeking enduring stability and long-term growth in their portfolios.

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