Global Real Assets: Making the case for infrastructure investing

GLASS BOX SERIES

For yield-starved investors, listed infrastructure can offer the best of many worlds, says Jim Lydotes, fund manager, Mellon Investment Management

As the US looks to ramp up spending on everything from highways to hospitals, Jim Lydotes, manager of the NBI Global Real Assets Income strategy, examines the benefits of investing in listed infrastructure.

"In our view," he says, "those adding exposure to physical assets through listed infrastructure equities should participate in the upside from rising global demand. By doing so, we think investors could also benefit from some of the defining characteristics of listed infrastructure: broad correlation to global equities with comparatively lower volatility and higher yields.

"In the case of the NBI Global Real Assets Income strategy, a broader infrastructure opportunity set also helps augment some of the asset class' attractive features."

THE YIELD ARGUMENT

Infrastructure assets generally have multi-decade useful lives and typically go through two distinct life stages: "build" and "harvest." The "build" stage usually consumes a heavy amount of cash as the asset is constructed and put in place. It then enters the "harvest" stage, with low additional cash needs. At this point, the asset begins to generate income, much of which can be distributed to shareholders as dividends. Most infrastructure assets come to market (both in the public and private space) in the "harvest" stage, meaning investors ultimately buy the right to those distributable cash flows. This explains why infrastructure assets generate higher-than-market yields and are well suited to income generation.

For Lydotes, this characteristic of the asset class – its ability to generate income – potentially opens the door to a far broader, and potentially more profitable, understanding of what constitutes infrastructure investing.

"Given most infrastructure assets trade hands in the "harvest" stage, the main task for investors is to assess the level and predictability of those distributable cash flows," he explains. "When viewed in this way, as long as the asset satisfies the criteria of generating stable, predictable cash flows as an asset owner/rent collector, the opportunity set expands greatly.

"The team managing the NBI Global Real Assets Income strategy has always viewed the opportunity set through this expanded lens, and this has allowed the team to be much more discerning on the prices paid for assets owned, resulting in a more favorable yield profile than our peers."

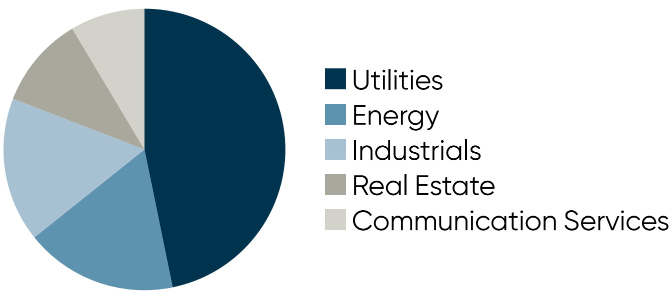
THE QUESTION OF VOLATILITY

Around 46% of the allocation of the NBI Global Real Assets Income strategy is to utilities, with another 8% to telecommunication infrastructure companies. Both sectors have historically offered lower levels of volatility versus others. A further 17% of the strategy holds companies in the energy sector, but typically, these are in companies that offer utility-type returns. In the industrials sector where the strategy has a close to 18% allocation, typical holdings include toll roads, mail/logistics businesses and airports.

Says Lydotes: "On the surface, it might seem as though the strategy has exposure to historically volatile sectors such as energy. When digging deeper into those exposures on a company basis, we don't own

the more volatile types of business in those sectors. Instead, we take a more nuanced approach where we look to invest in stable businesses. With this approach, we aim to dampen volatility to create more sustainable long-term returns for our clients."

Sector Weights



A BROADER OPPORTUNITY SET

Infrastructure funds are typically limited to a narrowly defined range of physical assets—transport, energy and utilities. The NBI Global Real Assets Income strategy is different. Its field of focus also encompasses such 'non-traditional' areas as telecom infrastructure assets, hospitals and acute care facilities as well as senior living properties. While these areas may be considered unorthodox for a listed infrastructure fund, they can still offer the same characteristics of the more traditional infrastructure opportunities, namely steady, cash-generative businesses where investors can access the benefits of owning the underlying physical assets.

Says Lydotes: "On a global basis, our peers are generally investing in around 75 stocks. But by looking at additional areas, we have an opportunity set of around 500 securities. That broader opportunity set separates us from the herd and allows us to be more discerning on valuations – we're not as beholden to owning that comparatively small list of companies.

TRADITIONAL VERSUS NON-TRADITIONAL AREAS OR EXPOSURE

Traditional			Nontraditional
Transport	Energy	Utilities	Communications & Social Assets
Bridges	Extraction (petroleum/ gas)	Electricity distribution	Satellites
Tunnels	Power plants	Gas distribution	Television transmitters
Toll roads	Oil and gas pipelines	Water distribution	Hospitals
Railways/ public transport	Renewable energy (wind power, solar cells, etc.)	Water treatment	Prisons
Seaports, airports		Waste treatment	Schools, universities

THE ADVANTAGES OF LIQUIDITY

Spending on US infrastructure is expected to rise in coming years. But the same also holds true in other parts of the world. Consultant Roland Berger, for example, has estimated emerging countries will need to invest up to US$851 billion a year across electricity, water, transportation, telecommunications and irrigation industries to secure future growth.[1] Likewise, the World Economic Forum expects a future global population of 9 billion people will need an extra US$5 trillion to be invested in infrastructure each year.[2] Clearly, there is significant pent-up future demand.

What's less certain is the timing and exact nature of any of this investment. Given this, the ability to be tactical is a distinct advantage due to the rapidly evolving legislative and administrative landscape. Investing in listed equities allows investors to arbitrage assets against each other constantly. Private allocations are inherently less nimble due to liquidity profiles and investment lock-up features.

1. http://www.rolandberger.com/media/press_releases/512-press_archive2012_sc_content/Privatinvestoren_fuer_wichtige_Infrastrukturen.html
2. The Green Investment Report, 2013 http://reports.weforum.org/green-investing-2013/required-infrastructure-needs/

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Says Lydotes: "You can avoid equities and buy directly into infrastructure opportunities, but unless you have tremendous scale, you will not get project diversity – and you are likely subject to multiple-year lock-up periods. By investing in publicly listed funds and companies, you benefit from project diversity and daily liquidity in securities actively traded on an exchange."

BENEFITS OF INVESTING IN LISTED VERSUS PRIVATE INFRASTRUCTURE OPPORTUNITIES

	Publicly Listed Funds	Private Infrastructure Funds
No Lock-Up Period	X	
Cost Advantage	X	
Uncorrelated to Equities		X
Dynamic Positioning	X	

For the future, Lydotes remains a strident advocate of listed infrastructure investing. "In our view, it's undeniable that we're in the early stages of an infrastructure boom," he says. "The case for spending on physical assets has been building for decades and, in our opinion, is an attractive opportunity in its own right. We believe those who add exposure to physical assets through listed infrastructure equities, particularly if they take into account a broader investment universe that includes social infrastructure, should be well placed to participate in the upside from rising global demand."

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