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The influence of direct investors in infrastructure investing

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The infrastructure market has undergone a seismic shift since the world was hit by a financial crisis in 2008. A combination of globally low interest rates, a flight to high quality and yield-bearing assets and an enhanced desire to invest directly have broadened the infrastructure investor community whilst significantly raising prices.

The impact has been pronounced, with many investor types including Sovereigns now directly investing into infrastructure-owning businesses across the developed world. As their investment experience has broadened, so in turn has their appetite. Now some of the most established, reliable European investors hail from teams in the Middle East and Far East, and established infrastructure funds need to re-establish their positions and deliver sharper value propositions to investors.

The steep rise in prices has led some to question the sustainability of the sector, however the long-term nature of both investors and assets, and the belief in longer-term low interest rate environments suggest that appetite for these assets is unlikely to dissipate.

A broader community

The most obvious shift in recent years has been the appetite of Sovereign and State-owned investors to invest in Western infrastructure assets. London Heathrow airport now has seven investors from seven countries, including state-owned vehicles from China, Qatar and Singapore. Meanwhile its biggest competitor, London Gatwick, has five owners including state-owned funds from Abu Dhabi and Korea, and pension funds from Australia and Canada. China and Abu Dhabi also supply London's drinking water whilst Hong Kong keeps its lights on.

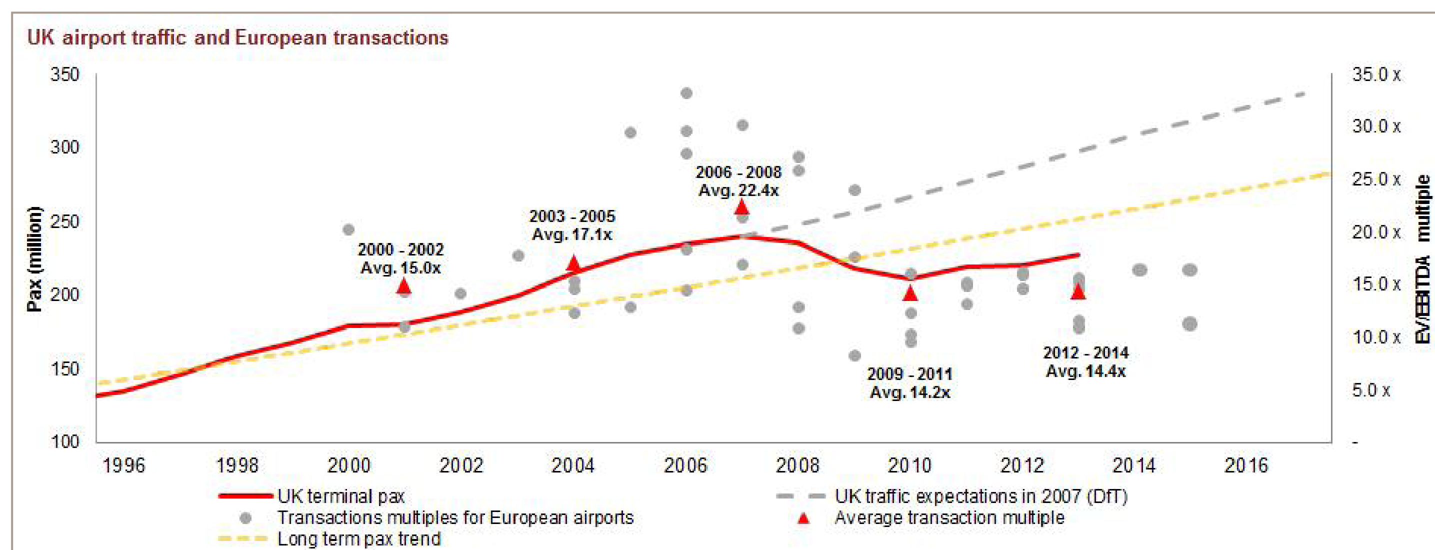
Outside the UK, Sovereign Investors have invested far and wide – including ports in Australia, electricity businesses in Spain and Danish renewables.

But it isn't just Sovereign Investors who have joined the infrastructure investor community. Attracted by strong fundamentals including strong equity returns and perceived low-risks, many investors have turned to infrastructure. Examples include Canadian retirement schemes, Japanese trading houses, British university pension funds, German insurance companies and Chinese State-owned enterprises. With interest rates on government gilts at rock-bottom levels, infrastructure has been one area where investors can still expect a dependable cash return.

Appetite for yield pushing up prices

The impact on this chase for yield has of course been a sharp increase in the prices investors have been prepared to pay for investments. With banks and other institutions freely offering debt into the sector at historically low prices, willing vendors have seen it as a perfect time to sell assets, and those who have effectively run sale processes have seen impressive returns. A recent public example saw one listed fund selling its 33% stake in a rolling stock company for £358m in January 2015, having valued it in its accounts at £160m just one year previously.

In the airports space, valuations have risen steadily since the crisis, with investor confidence increasing in line with passenger numbers although, as can be seen below, valuation multiples are still some way off their pre-crisis peak.



Fuelling a bubble or seeing the longer-term?

Whilst a degree of price inflation will be inevitable as the general economy strengthens and confidence returns, the recent growth in prices has led many investors to question whether we are seeing the emergence of a bubble. A powerful combination of asset scarcity and low-cost capital has had a multiplier effect – pushing multiples up as improved asset performance has also increased underlying earnings. As one well-known market commentator recently observed, 'the biggest mistakes are made when times are best'.

And yet when the onion is peeled back, it becomes more difficult to argue against the core investment tenets: these are long-term investors, able to take a much broader perspective on assets' lifecycles. The acquisitions are not funded by rocket-fuelled debt levels, and wafer-thin equity structures (indeed debt levels have remained relatively stable in comparison with equity returns). Instead, investors are taking a view on acceptable asset returns and yield levels which, when compared against gilt returns, look positively healthy.

A common mistake of the last financial crisis was to assume that finance market conditions would remain indefinitely – indeed some acquisition models assumed they would continue to improve. This led to a crunch when precariously tight acquisition debt structures came up for refinancing, or assets failed to deliver against valuation models and debt covenants.

If a mistake is being made this time round, it will be in the assumption that low interest rates are here to stay – but this isn't an issue that should lead to an equity wipe-out, rather than creating a group of lower-performing assets sitting in a long-term structure.

Keeping the wheels on the track

Instead, perhaps, the main challenge will be for this new wave of direct investors will be in managing the performance of their assets. Recent history has shown that infrastructure businesses have performed extremely well under focused private ownership. Since the first major wave of infrastructure investing in 2005-7, asset performance has consistently improved, with record assets performances recorded, as evidenced by the charts below from the UK water sector.

However, most of the improvements have been driven by teams of professional investors – funds set up specifically to improve asset valuations, with appropriate remuneration structures. Many direct investors (pension, insurance and sovereign wealth funds) haven't yet evolved sufficiently to set up strong asset management teams, are often based on different continents from their investments, and regularly find themselves investing as part of complex investor structures – such as those seen at London's Heathrow and Gatwick airports, as discussed above.

Across the infrastructure space (and more widely), achieving high levels of asset performance has generally been achieved through giving management teams clarity of purpose whilst also providing appropriate scrutiny and supporting investment. Whilst there is no reason why direct investors should not be as successful in asset management as specialist funds (indeed some have already proved themselves more than capable), we consider this likely to be a considerable challenge for many. The need for a professional asset management firm may well find itself from within the direct investor community.

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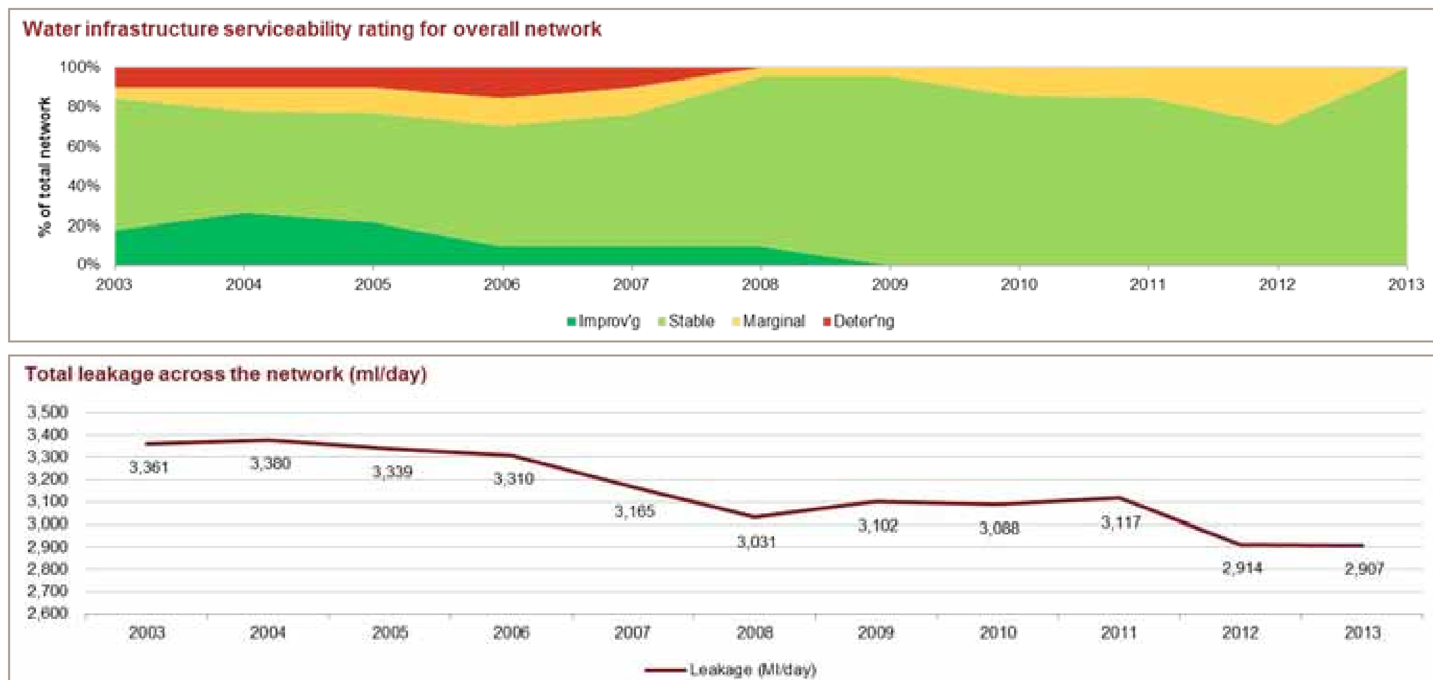

Conclusion

In conclusion, Sovereigns and other global investors have provided strong impetus into the infrastructure investment community. Their preference for long-term returns and essential assets is in perfect alignment with the asset class, which explains why so many are focusing on it.

However, the combination of a strong appetite and a scarcity of good assets has pushed valuations up significantly, and given vendors an opportunity to push aggressive 'sale-focused' business plans. In the heat of the deal, mistakes are likely to be made – although as the overall investment tenets appear robust, we consider these unlikely to be fatal.

It does, however, emphasise the need for caution in deal-making, in undertaking appropriate levels of due diligence, and making sure that the underlying asset performance is properly understood and evaluated. In our view, delivering outperformance will continue to depend on investors having a clear view on how a business should be managed and what it can be expected to achieve.

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