Competitive pressures

Soaring demand for infrastructure, together with a limited supply of assets, has led to high prices and yield compression. Maven Libera director **Megan Raynal** tells us how investors are reacting

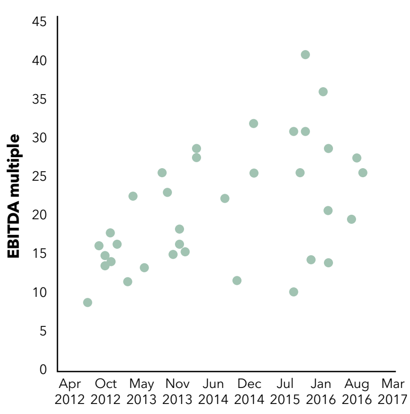
Infrastructure as an asset class has become increasingly popular over the past 10 years. These investments generally provide high and stable yields, which are attractive to superannuation and pension funds focused on providing returns for ageing populations. Recently, though, returns have been impacted by a number of trends.

For example, an ageing population among the OECD member nations means stable high-yield investments are likely to remain in demand. Both domestic and large international superannuation/pension funds have therefore had an increasing focus on infrastructure and have allocated significant funds to invest in it.

However, supply has not kept up with demand. Invesco has found that in 2017 most international pension funds expect to take four years to reach their allocation targets, versus three-and-a-half years in 2016.

THE MULTIPLIER EFFECT

Rising demand, competition and constrained supply driving up multiples in the port, airport and toll road sectors



Source: RARE

In Australia and in the UK, there has been increased scrutiny of foreign investment in infrastructure on national security grounds. Some transactions have even been halted, such as the sale of Ausgrid to foreign investors, blocked in Australia in 2016 due to national security concerns (despite the headlines, though, only five investments in the past 15 years have been halted in Australia). The country has also seen an increased tax office focus on the use of stapled trusts, which may reduce tax benefits for foreign investors.

HEATING UP

Another visible trend over the past few years has been fierce competition for key infrastructure assets, resulting in higher prices, higher multiples and yield compression.

Our analysis of deals since 2012 indicates that, while there has always been a wide spread of multiples for different types of assets, there appear to have been deals at higher multiples in recent years. This is particularly true for large transport assets: the median EBITDA multiple for ports, airports and toll roads has increased from less than 20 times in 2014, to 25 times and 27 times in 2015 and 2016 respectively.

An analysis of global listed infrastructure since 2013 has shown that, while EBITDA multiples have been mixed, in general, dividend yields have declined. However, this is not the case across all assets and it is interesting to note that listed transport infrastructure has typically traded at lower multiples than unlisted infrastructure. This may reflect the nature of individual assets, with larger cornerstone unlisted transport assets reflecting control premiums. While control premiums are paid for unlisted infrastructure, in our experience, liquidity discounts are not typically considered. This may change if the market for infrastructure assets changes.

Infrastructure continues to perform strongly, though. In the year to 28 June 2017, the S&P Global Infrastructure index achieved a total return of 15 percent, outperforming the S&P 500 (10 percent), the FTSE 100 (11 percent) and the Russell 2000 (6 percent).

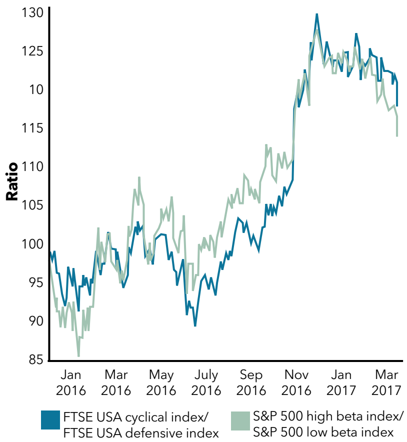
Competition for infrastructure assets may have also led to an increase in marginal projects. Infrastructure project defaults in the social and transport sectors increased in March 2017 to 5.8 percent – a rise of 23 percent on the prior year. The percentage increase was more pronounced on PPP projects, for which the default rate increased from 3.9 percent to 5.2 percent. The infrastructure project default rate is still below the overall project finance rate of 6.7 percent.

Competition aside, interest rates in many economies appear to be increasing – and in some economies, real GDP growth rates are forecast to rise. With higher interest rates, infrastructure, which is typically highly leveraged, could perform poorly.

However, analysis by AMP Capital has indicated that moderate interest rate increases could actually benefit infrastructure for a number of reasons. Many infrastructure assets are valued using discount rates that assume a higher long-term risk-free rate than the current spot rate. This will provide a buffer as rates increase. Some investments have long-term debt locked in at low rates; some infrastructure cash flows are linked to CPI or GDP and will therefore benefit from CPI growth or real GDP growth. Finally, some have high cash reserves, which could partially offset higher debt costs. Still, a significant increase in bond rates could negatively affect infrastructure values.

APPETITE FOR VOLATILITY

Defensive assets, such as infra, may lose some of their sheen as economies start to grow



Source: SPDR Blog, Bloomberg, 21 March 2017

Infrastructure is a defensive asset. As economies move into the growth phase, it may be that there is greater focus on cyclical assets, which benefit from economic growth, reducing demand for infrastructure. From July 2016 to the start of 2017, there was a strong performance of cyclicals versus defensives in all regions, coinciding with a recovery in bond yields from record low levels. However, in 2017 this performance has moderated as growth momentum has slowed. Research by Goldman Sachs shows that this trend has been broadly consistent across the US, Europe and Asia Pacific.

FULLY VALUED?

Infrastructure investors have responded in a number of different ways to these trends.

Some investors believe infrastructure is fully valued and are no longer actively pursuing the asset class. For example, in a Financial Review article in June 2017, Australian Super said they were keeping current investments, but not actively pursuing new ones (unless a great asset comes up), as they believed most infrastructure was now fully valued and were concerned that rising interest rates would put further pressure on returns.

Some funds may not be reducing their infrastructure targets, but the focus may have shifted from core infrastructure to assets with similar risk and return characteristics – for example, the recent purchase by Hastings of the New South Wales Land Registry. There has also been a bigger focus by many investors on infrastructure debt. Finally, there has been a move to more risky infrastructure assets, such as greenfield renewables.

Some of the larger pension funds are focused on more actively managing infrastructure assets to obtain better returns (similar to the private equity model), with the likes of the Ontario Teachers' Pension Plan not only investing directly, but looking to partner with more passive providers of capital.

In conclusion, high demand for infrastructure fuelled by an ageing OECD population and strategic investors, together with a limited supply of investments, has led to high prices and yield compression. This, coupled with increased restrictions on foreign investment and an increase in debt margins, has led some investors to stop actively pursuing infrastructure, while others have shifted from a focus on core assets to assets with similar return characteristics or assets further up the risk curve, or, finally, increased active management of infrastructure.