



UNDERSTANDING INFRASTRUCTURE

What investors need to know about this increasingly popular opportunity.

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Infrastucture has delivered excellent performance for some early investors in the asset class. In many cases, these were better returns than investors were entitled to expect for the risk they were taking. But free rides don't last forever, so is it time to pass on infrastructure or does it still have a place in an investor's portfolio?

Despite this run of past excess returns, there are good reasons for investors to continue to use infrastructure. Companies with appropriately structured ownership of infrastructure, as opposed to pure infrastructure development and construction companies, can deliver an investment positioned between listed equities and fixed interest in the risk/return spectrum. Investors should be rewarded for risk and, for this level of risk, an appropriate long-term investment return is about 5% more than CPI. This remains deliverable today; however, over and above this long-term return expectation, infrastructure investing has broadly offered, and continues to offer, three attractive investment characteristics:

1. By being different from either bonds or general equities, infrastructure provides diversification benefits relative to each of them;
2. As a real asset, with high visibility of cash flows, infrastructure can offer increased certainty of returns and a lower risk of capital loss;
3. With revenue generally linked implicitly or explicitly to inflation, infrastructure can provide some element of natural hedge against inflation.

Reap the benefits

To get these investment benefits, especially in today's environment, investors need to focus upon two issues. The first is to recognize that, in seeking these benefits, not all infrastructure is equal. There is a broad spectrum of investment opportunities that could be considered to be infrastructure and not all will deliver diversification, low risk of capital loss and an inflation

hedge. This type of infrastructure is characterized by revenue confidence, the clear capability to translate this into profitability, and the ability to do so for an extended period of time.

The second issue is prospective return. Today there is an imbalance between an increasing supply of capital, especially private equity capital, and the available investment opportunities, especially for directly held infrastructure. This imbalance has driven prices—in both the direct and listed markets—to levels that are now, in many cases, ahead of fundamentals. In the process, investors have enjoyed excellent rewards but the free ride is probably over. With an expensive market overall and with the prices of many assets above intrinsic values, there is still value to be found. The challenge now in achieving returns equal to, or even

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better than, long-term equilibrium expectations for the sector, has become greater and more of a focus on effective investment selection is required.

By carefully selecting a universe of the infrastructure companies from the deep pool of global listed infrastructure companies, investors can get the attractive risk characteristics of ownership infrastructure—diversification, low risk of capital loss and inflation hedge. By then applying disciplined bottom-up analysis to identify companies within this infrastructure universe having intrinsic values ahead of their trading prices, investors can still get a return equal to, or above, CPI + 5%. ■