

BUILDING THE Future

Coverage of the 2006 Infrastructure Investment Summit

BY CAROLINE CAKEBREAD

From bridges to roads to hospitals, pension funds are increasingly looking at opportunities to invest in key infrastructure services around the world. The long-term fundamentals are attractive and there are those who say infrastructure investing is the perfect asset class for pension funds. With that in mind, the Canadian Investment Review hosted the inaugural Infrastructure Investment Summit, which brought together plan sponsors from across Canada from June 14th-16th at the Fairmont Tremblant Hotel in Tremblant, Quebec. Against this gorgeous backdrop, the group explored the risks and opportunities of infrastructure investing.

The key points from the two-day discussion include: how to assess opportunities, how the market is shaping up in Canada, how to plan a successful deal and what

risks to keep an eye on. Each speaker at the Summit has provided a full summary of their presentation, which can be found at www.benefitscanada.com/infrastructure.

Assessing the Opportunities

Our conference opened with an update on overview of the latest research in the area of infrastructure investing by Peter Hobbs, head of global research with RREEF. The catalyst for the increase in investor interest in this asset class, Hobbs pointed out, is the attractive market fundamentals. "Such assets tend to have a high yield, steady growth in income and a low volatility." Plus, it is the nature of infrastructure assets to be long-term. "They tend to have a very long duration, generally with a minimum of 30 years, but often 60 to 100 years, and



they provide significant diversification benefits relative to bond and equity assets.”

Hobbs noted that infrastructure, as an asset class, remains emergent, and is still subject to the risks and opportunities associated with the materialization of any new asset class. That is why ongoing research is key, he stressed, particularly when it comes to assessing the best markets around the world. Key issues now being identified include precise definitions of the types of asset that comprise infrastructure, the existing and potential size of the market, behaviour characteristics and assessments of the relative attractiveness of markets around the world.

In particular, Hobbs said new research has identified three key factors in determining an infrastructure market's attractiveness. “The first is the size of the market,” he pointed out, noting that, in Europe, the largest economies of Germany, U.K. and France have an infrastructure market that is proportionately large.

“A second factor is the pressure on governments to privatize infrastructure assets,” said Hobbs. In particular, countries such as Germany, Italy, U.K. and Japan, as well as certain U.S. states, like California, have a low level of economic growth at a time of significant fiscal deficit. Such countries are under pressure to raise private finance to support their investment programs.

Beyond the scale of the market and the pressure to privatize, the third important factor relates to the experience of privatization. “This has implications for the scale of the pipeline of deals going forward,” noted Hobbs, and it “also impacts the degree of regulatory risks, with the more established markets such as Australia, Canada and the U.K. having generally lower regulatory risks than more emergent markets.”

The Canadian Experience

Canada is among the world leaders in infrastructure investment and a few presentations looked at the range of opportunities that exist across the country. Grant Main, vice-president, Partnerships British Columbia, talked about developments in his province. The Government of British Columbia established Partnerships British Columbia (Partnerships BC) and in 2002, the Capital Asset Management Framework (CAMF) was developed to assess alternative methods of satisfying B.C.'s capital needs. “Provinces across Canada are grappling with aging buildings, roads and healthcare facilities that are failing to meet the needs of growing populations,” Main said. In response, the CAMF

requires ministries, health authorities, and other public agencies “to think creatively and explore all procurement options for building and managing their capital assets.

“Since 2002, Partnerships BC has reached financial close on 11 projects with a total investment of \$4.3 billion, of which \$3 billion is private capital,” Main explains, adding projects have included the Abbotsford Regional Hospital and Cancer Centre, the Sea-to-Sky Highway Improvement Project, the Britannia Mine Water Treatment Plant and the Sierra Yoyo Desan Resource Road in northeastern B.C.

John McKendrick, senior vice-president, Project Delivery with Infrastructure Ontario, discussed his province's approach to the asset class. Infrastructure Ontario was established in order to carry out major infrastructure projects in the province. To combat the problem of deteriorating public infrastructure due to past neglect, the Ontario government implemented ReNew Ontario, a five-year, \$30 billion strategic investment plan to correct a formidable “infrastructure deficit” in the province and prepare for future growth.

To date, said McKendrick, “Infrastructure Ontario has been assigned over 40 major infrastructure projects through the Government's five-year infrastructure plan. A quarter of these projects are between \$50 million and \$100 million, a quarter are over \$250 million each and the remaining half are between \$100 million and \$250 million.”

Infrastructure Ontario is working hard to simplify the bidding process in order to reduce costs and increase deal flow. It will continue to have an open dialogue to ensure that its long list of infrastructure projects is delivered successfully. Infrastructure Ontario is working collectively with the private sector to make projects happen.

Focus on Energy

Delegates also heard from one pension fund currently involved in Infrastructure investing. Cyrille Vittecoq, vice-president, Investments, Energy Sector, Infrastructure and Energy Private Equity, Caisse dépôt et placement du Québec brought his expertise in the energy sector to the summit. “Energy Infrastructure has been one of the most fertile grounds in recent years for institutional investors looking for strong and stable cash-flow returns to offset the reduction in fixed income securities yields and availabilities.”

He points out that restructuring in the North American and global energy markets and the market

disruptions caused by years of under-investment have generated a number of opportunities and superior returns. However, there is also a lot more money aimed at finding those opportunities—and that means lower risk-adjusted returns going forward, he said. But, he said, that is likely to correct itself in the future.

Today, says Vittecoq, the major opportunities in energy infrastructure are coming from deregulation in markets such as Australia, England and some North American States and Provinces. “[Deregulation] is forcing utilities to make choices and focus on one or two segments of the business while selling the others,” he explained. In addition, the repeal of the Public Utility Holding Company Act in the U.S. in February 2006 is set to further open the electricity and natural gas sectors to new sources of investment in necessary energy infrastructure development.

When it comes to energy infrastructure, institutional investors have to be ready to take on risks that move them away from their initial objective (bond-like returns). The risks posed by this asset class are long lead times, environmental and NIMBY issues, inflation and cost overruns. All this needs to be kept in mind when approaching this growing area.

Structuring the Deal

When it comes to planning and developing a successful infrastructure project, you need a commitment—from both public sector and private sector participants—that they will collaborate and address one another’s unique needs and concerns. To make projects work, find the best way to approach and structure the deal up front, said delegate Brad McLellan, partner, WeirFoulds LLP and Dan Ferguson, partner, WeirFoulds LLP. “Early planning is a critical component of any successful project,” Ferguson pointed out. “The right approach requires that each participant must devote significant attention to early project planning, consultation with all involved parties, appropriate risk allocation, and the development of good project documentation and project management.”

At the same time, said McLellan, it is key that any infrastructure project adheres to a structure that satisfies five key guiding principles: 1) It must serve the public interest, 2) demonstrate value for money, 3) preserve appropriate public control and ownership, 4) maintain accountability and, 5) have fair, transparent and efficient processes.

In closing, McLellan advised delegates that any successful infrastructure project needs to achieve optimal risk allocation where risks are identified and agreed

upon and where appropriate controls and powers are transferred to the party assuming any given risk. In addition, “the final challenge to meet in creating a successful public infrastructure project is to address the need for proper ongoing project management,” he said. “Proper project management makes the best use of the strong foundation achieved during the early work of structuring and developing the project by ensuring that project operations are appropriately managed and monitored throughout the entire life of the project.”

Risks and Returns

“The free ride is over,” said Ian Smith, portfolio manager with Lazard Global Listed Infrastructure Fund. “Direct infrastructure investing has been a great risk and, on average, investors have received returns that outweighed the risks they were taking.” However, he said, the large reservoir of capital seeking infrastructure investments means that it will be increasingly difficult to gain access to deals.

“Investing is all about risk and return,” said Smith. “And so it should be for infrastructure. Except that today it’s also about access.” Where does that leave investors? Smith outlined what he sees as two separate positions on the risk-return spectrum for infrastructure—development versus ownership. “Infrastructure development is a high-risk investment that demands the expectation of returns above that of listed equities,” explained Smith. “By contrast, infrastructure ownership investors investing in assets that are already up and running and, in the risk-return space, can be positioned between listed equities and fixed interest.” With lower risk than equities and more risk than bonds, Smith said the risk of infrastructure ownership can be priced at “about inflation plus 5% per annum.”

In addition to steady returns, Smith explained that ownership infrastructure provides diversification and brings the benefits of a highly visible cash flow with a lower risk of capital loss. He also noted that it provides a natural hedge against inflation.

Since infrastructure investing is also about getting access to deals and the market is crowded, listed infrastructure is also an attractive alternative. Preferred infrastructure companies, listed on developed market stock exchanges, can be identified that meet the key investment characteristics that Smith described. “Investing in preferred global listed companies can deliver the attractive risk/return characteristics of ownership infrastructure, with a return that is better than the risk profile it deserves,” concluded Smith. ■