



# The Race for Assets

## Infrastructure: Building on Strong Foundations

By Alan Flanagan and Robert Wagstaff, BNY Mellon

**“We have increased our investment in infrastructure and are planning to keep it high. There is a clear need for infrastructure development. By investing in this space, we gain access to a sustainable long-term investment that offers low risks in comparison with other asset classes.”**

Head of Investment, Pension Fund,  
EMEA

### Record levels of investor capital in infrastructure



In the past few years, infrastructure has risen steadily to become a mainstay of the alternative asset portfolio alongside more established asset classes such as private equity. Over the last two years, infrastructure funds globally have attracted record levels of investor capital, with US\$54.3B raised in 2017 and US\$55.6B in 2016.<sup>1</sup>

Infrastructure’s popularity has been driven, in part, by the asset class’s strong returns, with 79% of investors in our recent *Race for Assets* survey<sup>2</sup> saying that it had performed in line with, or exceeded, their performance expectations. Satisfaction with returns is reflected by the survey finding that allocations were likely to remain broadly stable over the coming year, averaging around 18.5% of investors’ alternatives exposure.

Yet returns are not the only draw for investors. The long-dated nature of infrastructure investments may be a good match for the longer-term objectives and/or liabilities of insurance companies, pension funds and sovereign wealth funds in particular. In addition, the fact that infrastructure assets and projects often provide public good—from social housing and healthcare facilities to schools and renewable energy generation capacity—and that investment in areas such as roads, bridges and airports has a direct impact on economic growth, the asset class pairs well with the increased focus on sustainability and Environmental, Social and Governance (“ESG”) factors among today’s investors.

<sup>1</sup> Inframation Group

<sup>2</sup> BNY Mellon *The Race for Assets*. [https://www.bnymellon.com/\\_global-assets/pdf/our-thinking/the-race-for-assets-alternative-investments-surge-ahead.pdf](https://www.bnymellon.com/_global-assets/pdf/our-thinking/the-race-for-assets-alternative-investments-surge-ahead.pdf)

Infrastructure is also an area of investment that has plenty of scope to grow. It is estimated that US\$94T of investment is needed to maintain, upgrade and build infrastructure assets worldwide between now and 2040, and based on current trends, there will be a US\$15T funding gap.<sup>3</sup> It has been widely recognized that governments cannot meet this demand alone and that private sources of capital will be vital.

Nearer term, in the U.S., the Trump administration has called for US\$1.5T of infrastructure investment over the next decade, with just US\$200B<sup>4</sup> of this coming from the U.S. federal government. While precise plans have yet to be announced, the private sector will likely have an increased role in financing U.S. infrastructure projects.

**“In both the U.S. and Europe, we have seen margin reduction in standard and core infrastructure assets and an easing of financing terms. You have to seek out opportunities where the risk-reward is better and where there aren’t as many investors chasing the same deals.”**

Claus Fintzen, CIO and Head of Infrastructure Debt, Allianz

There is a clear need for infrastructure funding on a global level, with many emerging markets requiring the greatest amount of investment. With rapid urbanization and growing middle class populations, these countries urgently need investment in areas such as sanitation, transportation, energy, healthcare and education infrastructure. Emerging Asia, for example, will require US\$26.2T of infrastructure investment between 2016 and 2030 to support economic growth, combat poverty and respond to climate change.<sup>5</sup>

Despite this need, the long-term nature of many projects means that finding opportunity in today’s market can be challenging. This is coupled with healthy investor appetite. Our *Race for Assets* survey showed that 70% of investors currently had exposure to infrastructure debt, with 33% expecting to increase allocations in the next 12 months. Competition is fierce for many of the core areas, such as transportation and renewable energy deals, leading to an erosion of terms and margins. Given these circumstances, some funds are now looking to new areas to invest, with technology featuring more prominently in their strategies, including in areas such as data warehousing, smart meter and the installation of broadband capacity in rural areas.

### Calls for transparency driving innovation

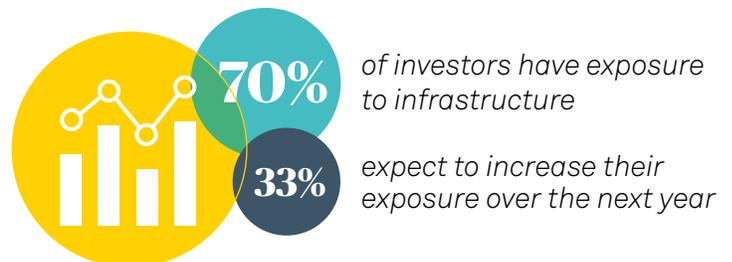
Despite investors’ overall satisfaction with infrastructure, transparency has become a major challenge. Nearly half (46%) of respondents to our survey said they were unhappy with the level of reporting they received on their infrastructure investments. This area of alternatives is trailing a long way behind strategies such as private equity, where just 7% said they were dissatisfied with transparency.

There are challenges to providing information on a timely basis to investors in infrastructure, given the timescales involved and the complexity of the investments. Data can take some time to filter through to investors. Yet if infrastructure funds are to meet investor needs, they need to invest in

technology architecture. Many are operating on outdated technology, and are often relying on manual processes. However, improved data capture from a variety of sources, together with analytics and secure cloud-based systems, offer the opportunity to simplify reporting procedures. This creates opportunity for outsourcing fund administration to third-party service providers, which

can now offer more up-to-date access to information that can be refined according to individual investor requirements. This increases efficiency and removes the need for heavy investment in back office personnel.

The need for investment in technology is even more acute as managers increasingly offer new products to their investors. Over recent years, open-ended infrastructure funds have emerged, for example, providing investors with the potential for windows of liquidity in what can otherwise be a 15- to 25-year investment. This is a welcome development for investors, but a complex one for fund managers. These funds require systems that can provide ever more up-to-date information to ensure investors can make effective decisions about investment and redemption.



<sup>3</sup> Global Infrastructure Hub, G20 <https://outlook.gihub.org/>

<sup>4</sup> Legislative Outline for Rebuilding Infrastructure in America, The White House <https://www.pnc.com/content/dam/pnc-com/pdf/corporateandinstitutional/MunicipalBond/white-house-legislative-outline-2-22-18.pdf>

<sup>5</sup> Meeting Asia’s Infrastructure Needs, Asian Development Bank. <https://www.adb.org/publications/asia-infrastructure-needs>

# The U.S. infrastructure debt market—a case apart

The U.S. infrastructure debt market has evolved differently from those in Europe, Canada and Australia. Funds and direct institutional investment tend to dominate the latter markets, and while private capital contribution to key infrastructure projects such as transportation, education and other social benefit-related projects has long been a feature of these markets, tax-exempt infrastructure bond (or municipal bond) issuance has been the main source of finance in the U.S. Nearly two-thirds of core infrastructure in the U.S. is financed with municipal bonds.<sup>7</sup>

Last year, more than US\$400B<sup>8</sup> of tax-exempt bonds were issued in the U.S. across segments including education, power, environmental facilities and transportation. Retail investors have historically been the market's mainstay, yet over recent years it has become an attractive area for institutional investors seeking yield.

Foreign investors, in particular, have been drawn by the market's low volatility and potential to provide diversification, even despite the fact that they do not qualify for tax exemption. Enhanced disclosure may also be an attraction.

As publicly-traded bonds, transparency requirements are high for municipal bonds (especially notable, as our survey reveals, transparency is an issue in the infrastructure market). At the end of 2016, foreign investors held US\$106bn in U.S. municipal bonds, up from US\$72B in 2010.<sup>9</sup>

Whether the Trump administration's infrastructure plans will provide scope for further investment opportunities remains uncertain as detail on their eventual shape is lacking. However, over the short term, the recently announced tax reform may slow the municipal bonds market—albeit temporarily—as investors take time to understand the implications for this part of the market.

## Direct investment on the rise

One of the key trends over recent times has been the rise of direct investment by institutions in infrastructure. Insurance companies and pension funds are seeking to deploy larger ticket sizes in the space, particularly as regulators in some regions have attempted to encourage infrastructure investment through, for example, reduced risk weightings in Solvency II capital requirements.

While markets such as Europe and Australia offer attractive opportunities, emerging markets are of growing appeal for many investors, with some interesting new structures materializing. In 2016, Allianz Global Investors signed a partnership with the International Finance Corporation to create their Managed Co-Lending Portfolio Program, which will raise a total of US\$5B to invest in emerging market infrastructure loans. Since then, the People's Bank of China, AXA and Prudential have also joined the initiative.<sup>6</sup>

Infrastructure investment is clearly a dynamic space with strong growth prospects and a capacity for innovation to meet both investor requirements and global demand for improved and new assets. There will be bumps along the road to further development, which may give investors pause for thought. One case in point is that of UK multinational infrastructure and construction services company Carillion, which collapsed in 2017, resulting in liabilities of close to £7B.

However, this event was not unforeseen and it may ultimately demonstrate the strength of protections put in place by funds as the workout process unfolds.

The prospect of rising interest rates may also lead to some investor capital being allocated to other areas. However, with so much funding needed worldwide in infrastructure space to support increased urbanization, decarbonization and increased digitization, investment opportunities look set to rise even higher.

**“When we invest, we like to understand the way managers run their firms so we can deal with any risk or issues effectively. Currently, our infrastructure managers do not provide us with this information, making it difficult for us to carry out our investments.”**

CEO, Sovereign Wealth Fund, EMEA

<sup>6</sup> <https://ifcextapps.ifc.org/ifcext/pressroom/ifcpressroom.nsf/0/4EEDF358D7DDF02085258043004B050E>

<sup>7</sup> American Public Power Association <https://www.publicpower.org/periodical/article/more-150-lawmakers-tout-municipal-bond-benefits-bipartisan-letter>

<sup>8</sup> Reuters <https://www.reuters.com/article/us-usa-tax-municipals/u-s-muni-market-faces-challenges-not-crisis-with-tax-changes-idUSKBN1EF02S>

<sup>9</sup> Federal Reserve/Van Eck <https://www.vaneck.com/blogs/muni-nation/foreign-investor-interest-municipal-bonds-grows/>



## Words of wisdom

### Three ways fund managers can help build foundations for success in infrastructure

**1** **Look to private equity as an example of how transparency can be improved.** Our survey reveals that investors are far more satisfied with the levels of transparency from private equity funds than they are from infrastructure funds. Managers need to examine how these funds are developing their systems and learn from their experience.

**2** **Watch out for rising interest rates.** Many investors have looked to infrastructure as a relatively higher-yielding asset class in a low interest rate environment, but as monetary policy normalizes over the coming years, some may consider switching to less complex, more liquid credit opportunities.

**3** **Explore more innovative solutions to attract investor capital.** Institutional investor demands are increasing, with liquidity and a desire to deploy large sums of capital at low cost among their key requirements. Managers will likely need to develop new structures and strategies to meet these demands.

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