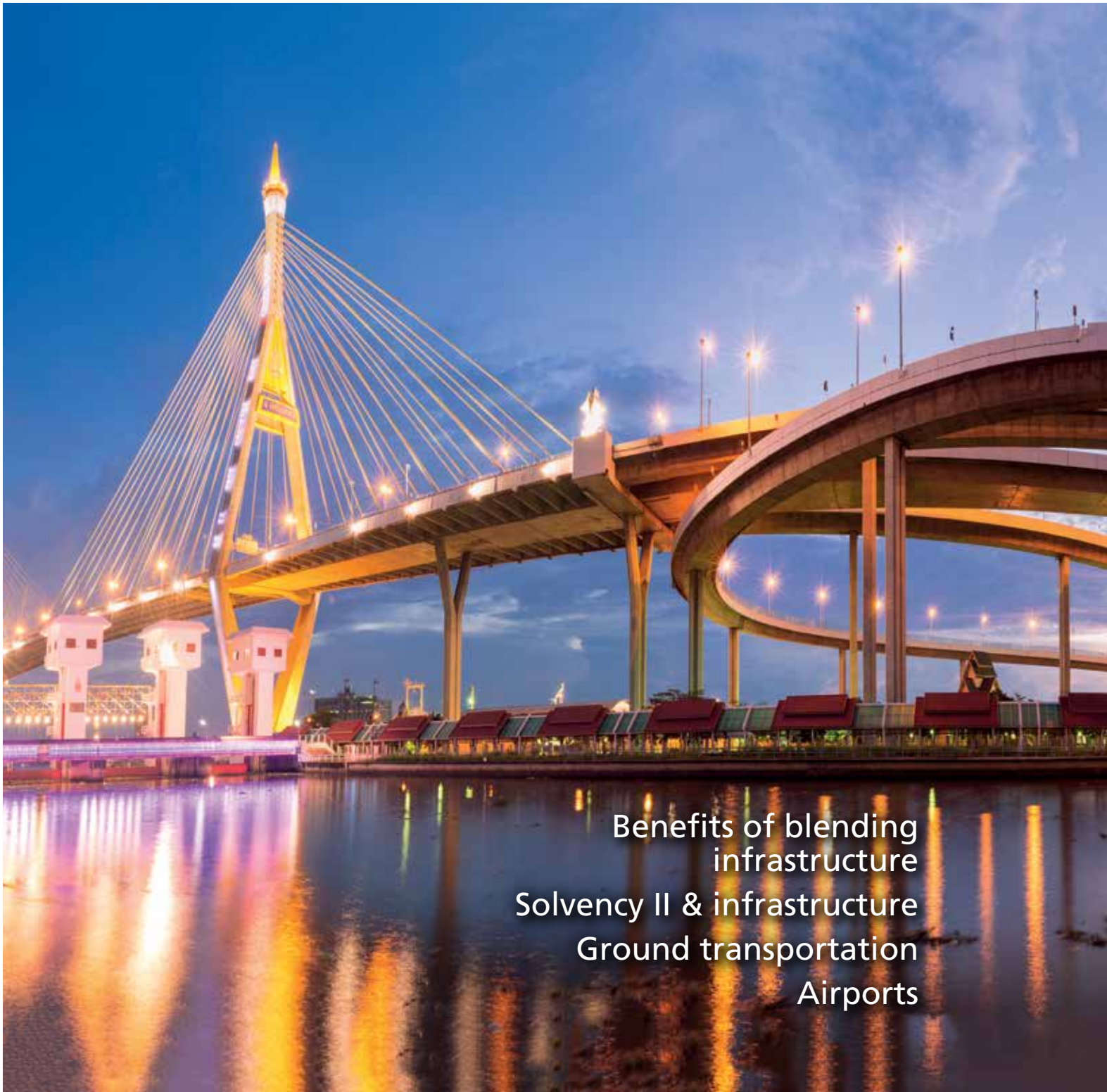




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Benefits of blending
infrastructure
Solvency II & infrastructure
Ground transportation
Airports

Listed infrastructure – a natural choice for insurers

Facing a challenging economic backdrop, institutional investors are navigating a prolonged low interest-rate environment in their search for yield. A growing sub-set of insurers is turning to listed infrastructure as an attractive asset class in which to invest.

Table 1: Qualifying Infrastructure Investment

Category	Equity investments	Debt investments
Vanilla investment (no change)	39% plus symmetric adjustment (Type 1). 49% plus symmetric adjustment (Type 2).	Spread risk charges as per Article 176.
Qualifying infrastructure projects (including project-like corporates)	30% risk charge plus 77% symmetric adjustment. ¹	Roughly a 30% reduction in the spread risk charges given in Article 176. ²
Qualifying infrastructure corporates	36% risk charge plus symmetric adjustment.	Spread risk charges as per Article 176, though certain assets may now no longer be securitizations.

Listed infrastructure is fast becoming the attention-grabbing investment sector. As it matures into a definable and quantifiable asset class in its own right, two key reasons stand out for this surge in interest, as highlighted by Preqin's 2017 Report:

- Availability of assets; a shortage in high-quality alternative assets with an attractive yield, which match the liability profile and risk appetite of insurers, has resulted in firms experiencing difficulties in sourcing appropriate direct investments in the private market.
- Capital efficiency; return on capital is a crucial metric by which insurers assess their investments. As a result of EIOPA's recent activity in encouraging investment in the listed infrastructure market (which we discuss further in this article), the return on capital of such investments may materially improve.

This article explores the benefit of insurers accessing the liquid infrastructure corporate market by considering the capital efficiency of a potential investment.

Proposed Amendments

One of the first concrete actions that the European Commission (EC) decided to take under the Capital Markets Union was to look at whether "infrastructure" should become a separate and distinct asset class under Solvency II. With a view to encourage investment in infrastructure, in its September 2015 advice, the European Insurance and Occupational Pensions Authority (EIOPA) recommended the introduction of a new asset class of qualifying infrastructure investments. Based on this advice, the EC adopted an amendment to the Solvency II Delegated Act in April 2016. In June 2016, EIOPA advised the EC to

define a new sub-class of investments in infrastructure to include infrastructure "corporates", i.e. listed infrastructure, though the advice has not yet been implemented within the Delegated Act. The main recommendations in the latest advice are as set out in the Table 1.

The trend to switch from Defined Benefit (DB) to Defined Contribution (DC) schemes, as well as the buyout and buy-in of DB schemes by insurers, is driving growth in assets under management long-term for insurers. According to UBS Asset Management, over the last decade DC assets have grown in the UK at a rate of 7.1% per annum, while DB assets have slowed to a rate of 3.4% per annum. At the end of 2016, the split was 68:32 for DB/DC assets in the UK. The markets with a bigger proportion of DC assets relative to DB in 2015 are Australia with 87% and the USA with 58%.

As allocations to asset classes such as real

Listed infrastructure companies generally operate with regulated (index-linked) contracts, which cut out income fluctuations and act as a hedge against price inflation.

estate, infrastructure and commodities are envisaged to increase significantly in the future, according to many market experts, demand for investment vehicles in these asset classes will continue to strengthen.

The latest advice from EIOPA, coupled with expected growth in long-term assets under management for insurers, offers an opportunity for both private and listed infrastructure investment. Both options can offer a variety of benefits to investors depending on their investment horizons and the underlying exposure they seek.

Benefits

With a focus on global listed infrastructure, annualized total returns and risk/return ratios have beaten the equities market consistently. Listed infrastructure companies generally operate with regulated (index-linked) contracts, which cut out income fluctuations and act as a hedge against price inflation. The broad diversification benefits of investing in a portfolio of listed infrastructure companies are attractive, with core exposure to a range of essential assets such as transportation, multi-utilities, energy generation and transmission. Each company will typically own between five and 50 assets.

The public markets offer the security of governance, transparency and reporting requirements/standards. In particular, a key benefit for insurers is the liquidity offered by listed infrastructure companies, which obviously compares favorably against long draw-down periods for direct infrastructure investment. In addition, understanding the changing regulatory and political environment for infrastructure investment means >

¹ Article 169(3) of the Solvency II Delegated Act ² Article 180(11) of the Solvency II Delegated Act

Table 2: Infrastructure Companies & Solvency II

Company	Country	Sector	FF MC	Yield	5 years	7.5 years	10 years	12.5 years	15 years	Lower Capital Charge?
National Grid	UK	Multiutilities	44,667	4.3%	15.7%	14.8%	9.2%	13.0%	11.6%	Yes
Kinder Morgan	USA	Oil & Gas Distribution	40,283	2.3%	-7.1%	-NA-	-NA-	-NA-	-NA-	Yes
TransCanada	Canada	Oil & Gas Distribution	39,896	4.1%	11.8%	12.9%	9.1%	10.9%	11.7%	Yes
PG&E	USA	Electric Utilities	31,338	3.0%	13.0%	11.0%	7.3%	10.4%	10.5%	Yes
Williams Co	USA	Oil & Gas Distribution	20,526	4.1%	4.6%	14.8%	6.4%	12.8%	6.0%	Yes
Transurban	Australia	Highways & Railways	14,617	4.1%	21.8%	20.9%	10.6%	12.8%	13.3%	Yes
Atlantia	Italy	Highways & Railways	12,183	4.0%	20.8%	12.5%	6.3%	8.3%	12.3%	Assets outside EEA & OECD
Abertis Infraestructuras	Spain	Highways & Railways	10,876	4.7%	12.8%	9.3%	4.5%	8.9%	11.6%	Assets outside EEA & OECD
Auckland Intl Airport	New Zealand	Airports	4,390	2.8%	30.6%	27.5%	17.9%	18.7%	18.3%	Yes
Zurich Airport	Switzerland	Airports	4,060	3.0%	28.1%	20.9%	10.7%	22.1%	17.6%	Yes
Eurotunnel	France	Highways & Railways	4,050	2.8%	9.4%	5.4%	-NA-	-NA-	-NA-	Yes
China Merchants Port Hldgs	Hong Kong	Marine Ports	3,536	3.8%	0.5%	1.3%	-0.8%	8.3%	12.4%	Assets outside EEA & OECD
Aeroports de Paris (ADP)	France	Airports	3,433	2.3%	16.5%	11.5%	7.4%	-NA-	-NA-	Yes
Grupo Aero Pacifico (GAP)	Mexico	Airports	3,366	3.1%	34.8%	27.1%	18.9%	-NA-	-NA-	Assets outside EEA & OECD

Source: Reuters, GLIO, EY, as March 31, 2017

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liquidity offers the ability to adjust exposure accordingly, which is something that cannot be done easily in the private market.

The regulation gain

With the Solvency II risk categories in mind, we analyzed a selection of 25 companies across the GLIO coverage, to understand if investment in these companies could benefit from a lower capital charge under the Standard Formula as per EIOPA's latest advice. The full analysis is available from GLIO on request.

At a high level, the proposed qualifying requirements for infrastructure corporate equities aim to target companies whose infrastructure assets provide or support essential public services, generate predictable cash-flows and are located in the EEA or in the OECD.

Table 2. ranks the a selection of key infrastructure companies by free float market capitalization, and includes current dividend yield and mid to long-

term annualized performance figures from five to 15 years. The final column indicates if the company is likely to benefit from the lower capital charge. Topping the list is the National Grid (UK), an electricity and gas utility company focused on transmission and distribution activities in the UK and the USA, the company is likely to satisfy the qualifying criteria for the lower capital charge.

In addition to the companies selected for analysis, it is important to note that some companies (such as water companies) who were previously treated as a Type 2 securitization (and hence received a 100% capital charge under the Solvency II Standard Formula) could now qualify as an infrastructure corporate equity under the new advice. This is a major development and could potentially significantly increase the attractiveness of these assets.

Scope for inclusion

Further analysis is required on the companies not classified as a 'yes'. In particular, Article 164a(1)(f) states

that, “the infrastructure assets and infrastructure project entity should be located in the EEA or in the OECD.” In the majority of company cases in the table, the largest portion of assets will be located in the EEA or the OECD.

Atlantia is a good example; it manages over 3,000km of roads and two airports in Italy, making up approximately 90% of its revenue according to its 2015 figures. The remaining 10% of Atlantia’s revenue is generated from approximately 2,000km of roads in Brazil, Chile, India and Poland, which sit outside of the EEA or OECD. While EIOPA may seek to apply the higher capital charge, despite the limited exposure to non-EEA or OECD

countries, this treatment may evolve over time if it materially reduces investment in infrastructure in Europe and further afield.

Once the advice is formalized and approved by the EC, the favorable treatment to these infrastructure investments would provide insurers a better alternative to the vanilla infrastructure investments. Especially in the current low-yield environment, the potential higher yielding and lower risk charges from listed infrastructure investments would improve insurers’ solvency position. 🌐



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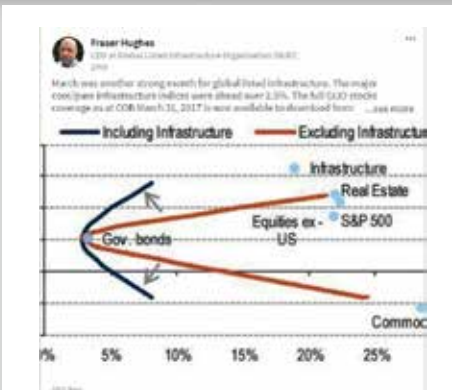


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