Coming into its own

Photography by: Lea Rubin

As listed infrastructure continues to evolve and mature, two leading professionals explain why it's deserving of investors' attention and money

A year has passed since *Infrastructure Investor* sat down with another group of professionals to discuss the merits of listed infrastructure and since then, the world seems to be a different place.

Between last September and late July, when *Infrastructure Investor* met with Wilson Magee of Franklin Templeton Investments and Jeremy Anagnos of CBRE Clarion Securities, Paris suffered the deadliest attacks on French soil since World War II, at least 35 people travelling through Brussels Airport lost their lives in another terrorist attack, and while not bloody, the UK's decision in June to leave the EU sent a different type of shockwave around the world.

These, and other events – more recently the failed coup attempt in Turkey – serve as a reminder that risk and the volatility it creates is very much alive and not just in one place. But volatility is a characteristic some investors, particularly those seeking stability in the infrastructure asset class, strive to stay clear of. It is also one of listed infrastructure's weaknesses, according to its critics.

"I think social media and the digitisation of all that we can consume has maybe made us all more aware of these things that are happening globally," Anagnos, CBRE's chief investment officer for infrastructure, says. "But I do think that risk factors, such as political and regulatory risk that meaningfully influence the asset class, are elevated and are increasingly changing for investors and they have to assess that."

To counter critics' claim regarding volatility, Anagnos draws on private real estate and real estate investment trusts and continues: "Numerous studies have said that you're effectively getting a proxy in real estate by investing through listed REITs. If you look at the comparison of the returns and the risk profile of private real estate and REITs, over time they are similar."

The reason the example is founded on real estate is because, Anagnos explains, while data on the listed side dates back 20 years, data on the private infrastructure side is limited. "Once we get better data on the private infrastructure side, you'll see that the return profiles are similar," he notes.

A key difference between listed and unlisted infrastructure with respect to volatility is that it's measured on a different basis.

"Many investors don't want to see the risk, meaning they invest in private

because they know that the asset gets revalued once a year," Anagnos continues. "But again, I think what we will start to see is these risk factors that are changing will create unrealised volatility that investors will see either when the asset gets sold or traded; or when an event occurs where they have to realise some liquidity and that will take time."

LIQUIDITY'S SOLID ADVANTAGE

Anagnos' last remark inevitably leads to another characteristic of listed infrastructure that is often cited, but in this case by its supporters – liquidity.

To illustrate the point, Anagnos goes back to the political and regulatory risk referenced earlier.

"What we've seen – and I'd say increasingly – is that those regulatory and political factors which, while based on very long-term investments, have very short duration cycles. One of the benefits of the listed market is that you can reposition your portfolio, your strategy to adapt to those changing risk profiles."

Magee, who is Franklin Templeton's director of global real estate and infrastructure securities and is hosting this meeting, echoes that view: "We can build portfolios quite quickly that are highly diversified. We can shift them, as Jeremy mentions, if we see different kinds of macro and regulatory influences that change our views. That is an opportunity to mitigate risk in a way that is difficult to accomplish quickly with private investments."

Another often-cited advantage of listed infrastructure is accessibility.

"Unless you have large institutional pools of capital, it is very difficult to get access to private infrastructure, whereas listed infrastructure is accessible to people with all sizes of capital pools and portfolios," Magee stresses.

Adding to that, Anagnos remarks: "Infrastructure is very diverse in terms of its sectors and geographic exposure, so it's hard to have expertise in all these areas. Some of these small plans have one or two people overseeing both real estate and infrastructure. If they have to commit capital to five different funds for their infrastructure portfolio alone, it's a difficult thing for a two-person team to do in addition to all their other responsibilities.

"Listed infrastructure gives them access to the asset class, a diversity of exposure and then maybe they can have one or two opportunistic funds or value-add funds [in their portfolio] that would be more return-enhancing within the asset class," Anagnos concludes.

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STRIKING A BALANCE

So, what is the ideal balance within an infrastructure portfolio in terms of listed versus unlisted investments?

Anagnos' reply comes as a bit of a surprise. "For smaller investors you might want to have maybe even up to 100 percent of your exposure through the listed market because of the cost," he says. "It's much cheaper from a fee perspective," he adds.

"The only thing I would add to that is I think even large institutional investors will use public and private together," Magee says. "I think there's an interesting tactic for those large investors because there are ways to create an overall portfolio blending the public opportunities you have – quite specific ones – with what you might find available in private investments, including funds."

While liquidity and accessibility are often put forth as arguments for listed infrastructure, Magee touches on an issue that he believes is overlooked.

"You see very low IRRs on private infrastructure investments," he states. "To increase equity IRRs there is a much higher use of leverage and I think people underestimate the volatility that leverage can create. I know today the world is less worried about leverage because it's readily available and very cheap but that's not going to last forever," Magee continues.

"And when you dispose of private assets you might end up in a market where the debt capital has a very different set of characteristics than it does today. As a result, it will be highly influential to the pricing, the equity returns," he explains.

Magee's statement is not based on theory and one only need to refer back to the global financial crisis to understand the practical implications of what he describes.

"A number of toll road assets went into the crisis with too much leverage," Anagnos recalls. "The investors lost the asset and gave it to the creditors. It's an extreme example of taking a core asset and turning it into a highly risky asset."

HIDDEN FEES

The issue of leverage is not the only one surrounding the listed versus unlisted infrastructure debate that Anagnos feels does not get the attention it deserves.

The other is the fee structure of private market funds.

"I was at a private conference recently and the conversation that kept coming up was that many of the funds investors committed to post-crisis have a gross to net difference ranging from 600 to 700 basis points," Anagnos remarks. "As a result, a large portion of what looked like an opportunistic type of return goes towards high management fees. That is an underappreciated risk."

Magee provides further evidence citing a 2015 paper published by CEM Benchmarking, which calls for total fee disclosure in the private equity industry.

According to the paper, the SEC's Office of Compliance, Inspections and Examinations in 2012 began conducting "presence exams" of private equity firms. Presence exams are an initiative launched in 2012 in accordance with the Dodd-Frank Act, to examine newly registered investment advisers.

OCIE's findings, published in May 2014, revealed "violations or material weaknesses relating to expenses paid for advisory services in more than half the examinations," CEM stated in its paper. The body also found hidden fees, such as accelerated monitoring fees, undisclosed administrative fees not covered by the limited partnership agreement, and others.

"While extensive due diligence is usually performed prior to investing, oversight during the life of the fund is not rigorous," CEM said, citing OCIE's findings.

The Toronto-based benchmarking company also included an illustrative example of management fees, indicating that because of the lack of transparency and standardisation in fee disclosure, many costs are not reported. It also created a test scenario and found that the difference between reported costs and actual costs for a $3 billion private equity portfolio was nearly $61 million.

"If you look at what it costs us to buy or sell stock, it's tiny," Magee says to drive home the point. "And it's implicit; it's completely embedded in our performance, in our returns. It's also tiny compared to the costs of executing and implementing private transactions," he comments.

One of the factors contributing to lower fees on the listed infrastructure side – both Magee and Anagnos agree – is a host of fee pressures.

"We have to compete against a very deep, large market that's highly transparent regarding fees," Anagnos elaborates.

Pricing is also quite different between listed and private infrastructure, with Anagnos emphasising that listed infrastructure is trading at a discount of at least 20 percent.

"I would second that," Magee interjects. "As a general rule – there may be exceptions – but as a general rule, the pricing of listed infrastructure is typically much more attractive than the pricing of private infrastructure assets."

Having talked quite in-depth about the advantages of investing in listed infrastructure, the question then becomes: do investors appreciate what it has to offer?

RAISING AWARENESS

"In talking with institutional investors and explaining the benefits of listed infrastructure, I think there is an attraction to a dividend yield of 3.5 to 4 percent from the listed market side," Anagnos replies. "And those yields have been very consistent over the last 15-20 years. Investors also see the prospects for growth from listed infrastructure, a space which is organically driven since these companies have more than $4 trillion of assets."

What's more, the listed companies active in the infrastructure sector are mostly enhancing and upgrading existing assets; improving reliability and safety. They are generally not building new assets therefore they are not assuming greenfield or development risk, according to Anagnos.

ILLUSTRATIVE EXAMPLE OF MANAGEMENT FEES AND PORTFOLIO COMPANY FEES

FULL MANAGEMENT FEES	PORTFOLIO COMPANY FEES	
165 basis points (bps)	50 bps	
Assuming that the general partner is entitled to 20% of the portfolio company fees:	General partner receives 10 bps	Limited partner receives 40 bps
Typically reported management fees	= Full management fees - LP share of portfolio company fees = Net management fees = 165 bps - 40 bps = 125 bps	
Actual costs incurred by LP	= Full management fees + GP share of portfolio company fees = 165 bps + 10 bps = 175 bps	

Source: CEM Benchmarking

PRIVATE EQUITY ESTIMATED FULL COSTS AND REPORTED MANAGEMENT FEES

	Median annual cost based on net asset value	Costs in $m based on a $3bn portfolio
Full management fees	1.89%	$56.70
Internal monitoring costs	0.08%	$2.40
Carry/performance fees	1.49%	$44.70
Other fund-level and portfolio company fees	0.36%	$10.80
Estimated total direct LP costs (A)	3.82%	$114.60
Reported management fees (B)	1.80%	$54.00
Difference (A-B)	**2.02%**	**$60.60**

Source: CEM Benchmarking

Magee agrees but points out: "Investors continue to be reluctant on the volatility side. I think that's still a headwind for listed infrastructure. Unfortunately, with the financial crisis, you had such high correlations of assets during that period that return correlations on the listed infrastructure side also still look very high," he laments.

While he expects correlations to decline further post-crisis, "they may never look like the low correlations of private assets," Magee concedes.

As Magee and Anagnos have spent the past hour presenting listed infrastructure's benefits – some of them underappreciated – could it be a matter of just educating and raising awareness among investors?

"Yes," is Anagnos' resounding answer to what turns out to be a rather timely question, since the industry gained its own dedicated organisation in July.

"The purpose of the Global Listed Infrastructure Organisation is to educate the broader investment market about what global listed infrastructure is, what it offers investors and why it should be included in their portfolio," Anagnos explains. "That is an indication that we are starting the maturation phase."

The organisation has 11 founding members, among them CBRE Clarion, and according to a statement announcing its launch, will focus on expanding its network in the next 18 months seeking the support not only from fund managers but from listed infrastructure companies as well.

Another "milestone" Anagnos identifies is the dedicated category for infrastructure-focused mutual funds that US investment research firm Morningstar launched in April. "Before that, if you had a listed infrastructure-focused mutual fund it was in this gigantic equity-rolled category of a couple thousand funds," Anagnos explains.

"The Morningstar change is specific to the US, which is extremely important," Magee clarifies. Morningstar already had a separate infrastructure fund category for the SICAV market, which covers Western Europe and most of the rest of the world.

"I definitely agree with Jeremy that having a trade association for infrastructure, being able to depend on a variety of people to educate investors and potential investors on infrastructure besides those of us who are fund managers, can really help push this as an asset class or a very attractive segment of the investable universe," Magee adds. "It will also help define

infrastructure overall, which over time will be very important."

GEOGRAPHIC VARIATIONS

Asked whether they have seen a discrepancy in the level of acceptance of listed infrastructure based on geography, Anagnos replies: "Australia is ahead of the curve in understanding and appreciating the benefits of the asset class overall and then allowing for listed infrastructure to serve as a complement to direct infrastructure investments."

Magee also describes Australia as "a model" because of the large number of infrastructure assets that are privately run. "That really helps the country have an extraordinarily strong fiscal position," Magee says.

Speaking of fiscal positions, Anagnos refers to the fiscal pressures many governments around the world are facing. One example in the US is the water sector. "The sector needs an incredible amount of investment and yet it is almost entirely municipally owned," he points out, citing the toxic water crisis in Flint, Michigan that has placed the sector under increased scrutiny.

"Whether it's the public market that's going to come in or if private infrastructure gets involved and a fund manager like Brookfield begins funding a lot of this new water infrastructure, I don't know," Anagnos says. "But there's definitely a need for capital for government-owned infrastructure assets."

Anagnos' reference to Brookfield is provides an opportunity to seek comment on the Canadian fund manager's latest fundraise. Despite the high management fees, the lack of accessibility and liquidity that generally characterise private vehicles, Brookfield was able to raise the largest infrastructure fund ever at $14 billion in less than a year. So what does that say about core infrastructure and investors' commitment to private infrastructure?

"I think it clearly says that large institutional investors are looking for what they perceive to be differentiated risk and return profiles of their assets and private infrastructure is clearly meeting those needs," Magee replies. "I think that acceptance on the part of large institutional investors around the world really enhances the place of infrastructure over time – both privately and publicly." ■

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