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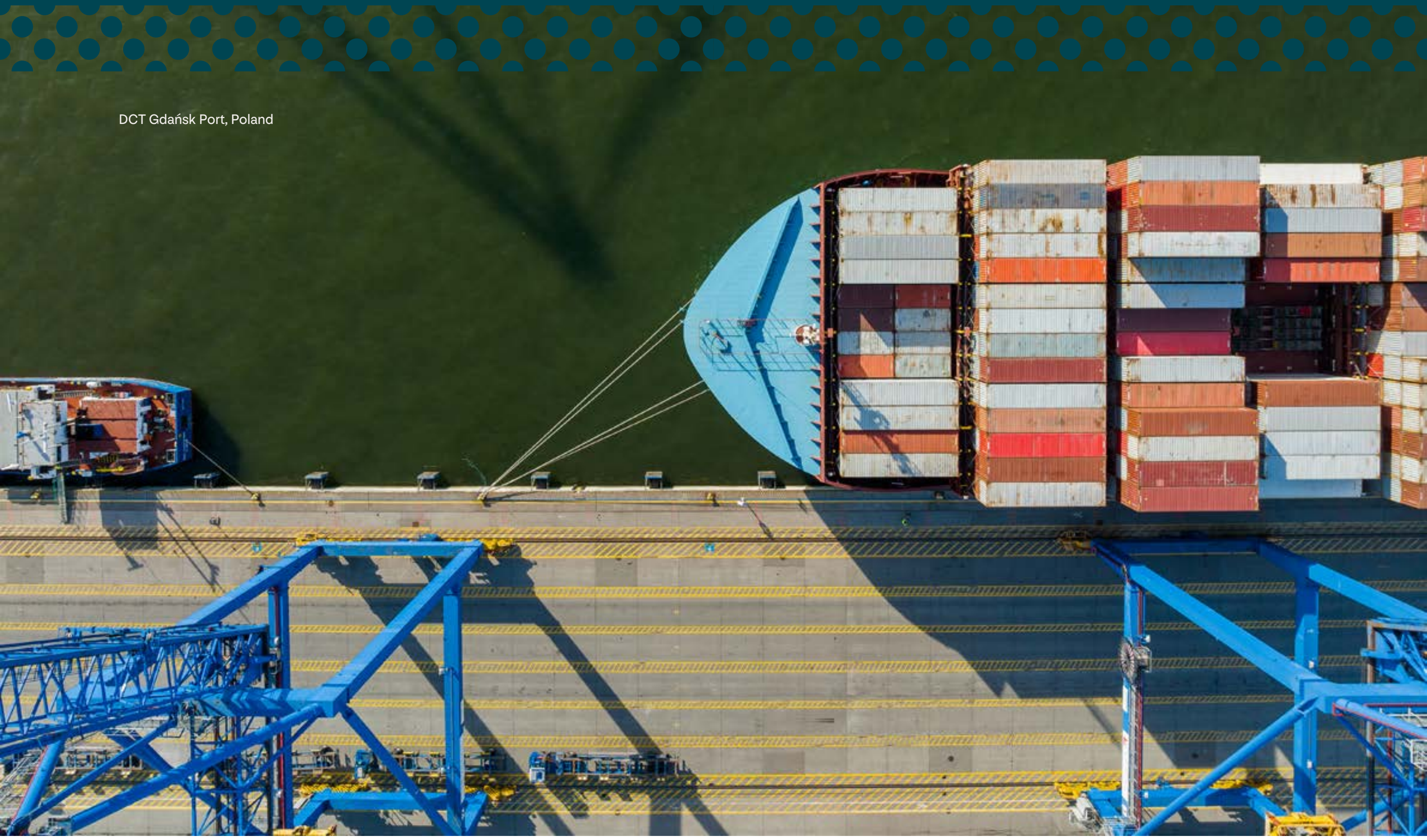

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Infrastructure is holding its own:

The rise of the infrastructure asset class

More than two decades since Australian superannuation funds first ventured into infrastructure, it is evolving globally as a standalone asset class.

Indiana Toll Road, USA

For decades, governments have been eager to attract private capital — and especially pension capital — to help fund the infrastructure spend their communities need. Well-established as a standalone asset class in Australia and Canada, infrastructure has become a mainstay of pension portfolios in both countries due to its ability to act as a natural inflation hedge and its lack of correlation with returns generated by listed equity and debt, which for decades were the foundational asset classes for any portfolio. But as interest in infrastructure increases across the globe, the time has come to consider it as equally vital to the performance of institutional investors' portfolios as those more traditional asset classes.

The Australian superannuation market is widely credited as having been the first to move into infrastructure investment in the 1990s. Spurred by the privatisation of the nation's capital city airports, this led to many — specifically the not-for-profit sector known as Industry Super Funds — to establish a private markets or alternatives allocation that encompassed the emerging asset class, as well as property and other unlisted opportunities.

Establishing Infrastructure

While Australia pioneered investing in infrastructure by creating a domestic market, Canada brought the concept to the wider world when allocating to the asset class. Following significant pension reform that saw eight major pension plans[1] build up in-house investment management expertise, known as the Maple model reforms, these funds began directly investing in infrastructure outside of Canada in the early 2000s, followed by a move by Australia's superannuation sector to solidify its exposure to infrastructure by investing overseas.

[1] The Maple Eight are now known as AIMCo, the British Columbia Investment Management Corporation, Caisse de dépôt et placement du Québec, the Canada Pension Plan Investment Board, the Healthcare of Ontario Pension Plan, OMERS, the Ontario Teachers' Pension Plan, and PSP Investments.

This first-mover advantage meant investors in both countries were able to gradually build up a dedicated infrastructure exposure, outside of a private markets or alternatives allocation. The growth in the sector has led to an increased maturity in the way assets are assessed, and the risks taken on by investors. With a track record spanning more than two decades, we can now conclusively say that the risks taken on by and returns enjoyed from infrastructure are significantly differentiated from any of the other asset classes that may sit within the private markets or alternatives sectors, meaning that infrastructure has truly come into its own as a standalone asset class.

Unlike equities and bonds, unlisted infrastructure's underlying return streams are highly linked to regulatory or contractual frameworks, associated with the nature of these assets as providers of essential community services. As witnessed over the last couple of years of pandemic, war and inflation, this means that the asset class can often continue to perform in such difficult economic climates, even where the macroeconomic environment will impact the returns of other mainstay assets.

Recent years of inflation and increasing interest rates have demonstrated the strategic importance of an exposure to infrastructure due to its resilience through economic cycles and effectiveness as an inflation hedge. We believe the infrastructure asset class has a role to play as a foundational portfolio asset class aimed at securing diversified, less volatile, low correlation long-term returns.

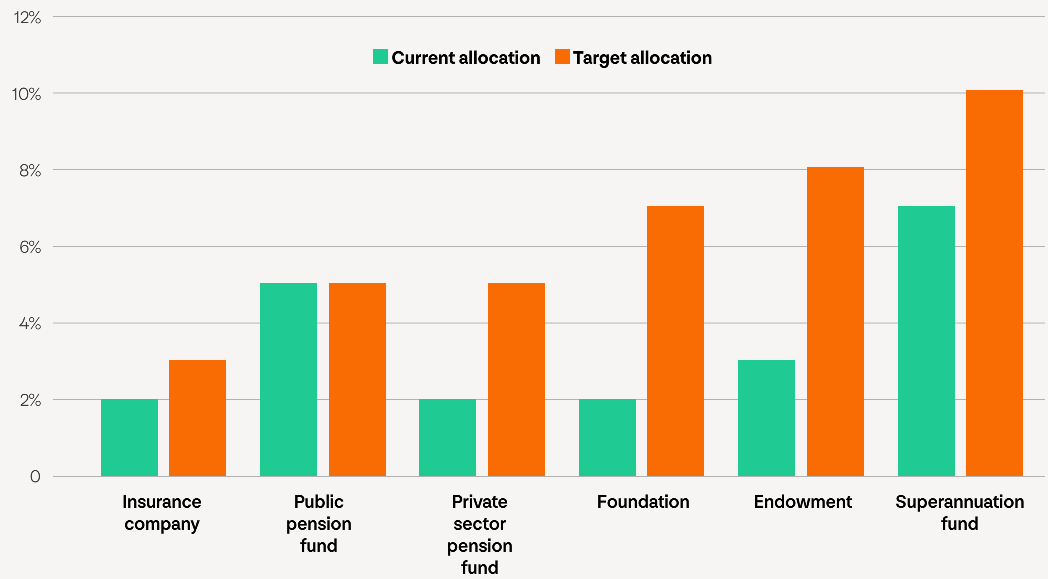
Looking beyond Australia

Despite the fact that infrastructure is established as a standalone asset class with established track records in the Australian and Canadian markets, Europe, Asia and the US are still, overall, placing infrastructure within an 'alternatives' allocation.

However, a number of countries within Europe have been making significant strides in the last decade, and governments have attempted to drive greater allocation to the asset class. In the UK, since 2016, English and Welsh local government pension

FIGURE 1

INVESTORS' ACTUAL VERSUS TARGET ALLOCATION TO INFRASTRUCTURE



Source: Preqin Global Report: Infrastructure 2024, data from 2023.

schemes have been required to set up collectively owned asset managers, in part to cut costs, but also with an eye on the schemes, which in 2022 had assets of £369bn, allocating a greater percentage of their funds to infrastructure. The country's rapidly growing defined contribution market is also exploring the asset class, with the National Employment Savings Trust (NEST), the country's largest defined contribution pension fund, among the first to make a meaningful allocation. Other pension investors have been building up direct and indirect stakes in the asset class in recent years, with Europe's largest pension fund ABP acquiring a stake in Australian electricity distributer Ausgrid in 2021. Even countries where infrastructure may have previously been viewed as part of the alternatives allocation are beginning to view it as a standalone asset class, with Switzerland recently amending investment rules for its second pillar pension funds to list it as its own asset class, and Germany is expected to implement a similar reform soon.

In parts of Asia, such as South Korea and Japan, asset owners have gradually built their exposure over the last decade. Korea's National Pension Service (NPS) disclosed a KRW41.1trn ($31.2bn[2]) allocation to infrastructure as of September 2023, equating to a quarter of its alternatives portfolio and 4.2% of its overall assets. Both the NPS' allocation to infrastructure and alternatives holdings have doubled in five years since 2018. For its part, the Government Pension Investment Fund, Japan's largest asset owner, first began investing in infrastructure a decade ago through a co-investment agreement with one of the Maple Eight, OMERS, gradually building infrastructure to be the largest allocation within alternatives, also comprising property and private equity. The fund announced last year that it would continue to build exposure and venture beyond its co-investment approach to directly allocate to select partners.

In the US, the scale of the market goes some way to explaining the scale of the challenge, and why it may remain a smaller allocation, relative to overall portfolios. In over a decade since 2011, the pension sector has committed significant sums to infrastructure, estimated at $134bn,[3] but this pales in comparison to the $40trn size of the market. The country's largest public pension fund, CalPERS, for example, has a significant allocation of $14.1bn to infrastructure, which only accounts for 3.2% of its $443bn portfolio.[4] Additionally, many of the more mature funds in these defined benefit (DB) markets struggle with the weakened funding and a future of negative cashflows, limiting their appetite for long-term, illiquid holdings, despite the generally stable cashflows associated especially with core infrastructure. Nevertheless, we believe the sector will work to increase its average infrastructure allocation of 3-4%, even if it has a long way to go before it can reach the level of allocation of Canadian funds, which, on average, have a 10.5% allocation.

US pension investors and those wishing to grow their exposure to the US will also see an increase in infrastructure opportunities in the coming years as the impact of the Inflation Reduction Act is fully felt. Half of the Act's $739bn in funding is allocated to clean energy and climate investments, resulting in a significant boost to renewable energy and energy security infrastructure, such as solar power and battery storage, significantly boosting growth in a sector that has already become, and is likely to continue to be, the single-biggest growth opportunity in the coming years.

It is clear from the examples above that investor appetite for infrastructure is not fully sated. According to Preqin's global report, in many cases, institutions continue to fall short of their desired target allocation by several percentage points (Figure 1).

[2] Currencies in this paper are in USD, unless otherwise stated.
[3] Major pension funds are steering big dollars to infrastructure (PIOnline.com)
[4] CalPERS seeks sustainable investments to grow infrastructure portfolio (realassets.ipe.com)

Broadening the definition of infrastructure

Today, maturity in the decision-making of long-term infrastructure investors can be contrasted with the opportunistic approach of investors to the asset class in the 1990s. Following decades of ownership, there is now a better understanding of the infrastructure sector, one that has seen a re-interpretation of what defines ‘core’ infrastructure and the returns expectation associated with it. Where airports were the foundation of many Australian infrastructure portfolios, they have since been joined by ports, energy transmission infrastructure and train stations.

Adjacent to these indispensable core infrastructure assets that often possess a strong market position, conservative leverage, predictable regulatory environment and high barriers to entry, is an additional universe of opportunities. The adjacencies could be contractors or suppliers to core infrastructure assets, such as water treatment facilities servicing the sole water utility in a region, or an intermodal facility servicing a seaport.

This broadening definition of infrastructure allows more flexibility as investors navigate market cycles and consider the appropriate time to include this foundational asset class within their portfolios in ways similar to Australian investors, allocating to these adjacent sectors as they open up to pension capital. Based on the established track record of the asset class, its resilience to macroeconomic challenges and its low correlation to other foundational asset classes, the attractiveness of infrastructure is becoming increasingly apparent.


Anglian Water, UK

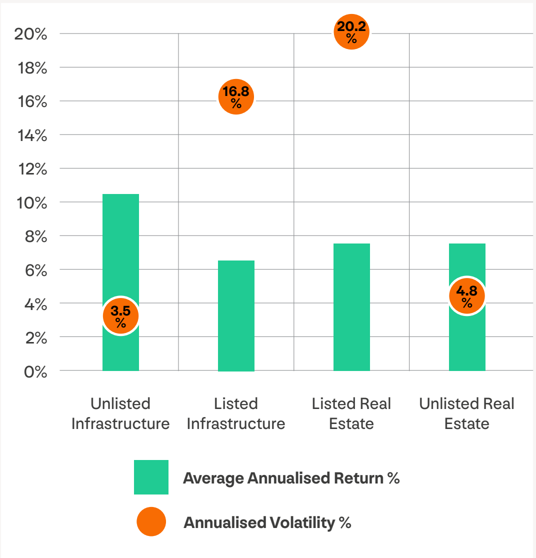
The next decade of infrastructure

The global energy transition will arguably be the most significant structural change undertaken since the early industrial revolution. Over the next three decades, over $100trn will need to be deployed to completely restructure our economy — much of which will take the shape of infrastructure equity funding for renewable energy and climate change adaptation methods.

Crucially, this need for additional capital coincides with significant — and potentially permanent — changes to other alternative asset classes. Since the COVID-19 pandemic heralded the advent of remote working, owners of office buildings have struggled with the lack of demand for their properties, reflected in the weaker performance of commercial real estate. A Deloitte survey of commercial property chief financial officers conducted in late 2023 found them predicting a second year of declining revenues, with two-thirds of respondents in Europe and 60% of those based in North America predicting a continued decline.[5]

FIGURE 2

AVERAGE RETURN AGAINST ANNUALISED VOLATILITY



Sources: OECD, MSCI, Bloomberg, Burgiss Universe Analytics.

Asset class performance reflects the change in the returns of the following indices: Unlisted Infrastructure – MSCI Global Quarterly Private Infrastructure
Asset Index (Unfrozen); Listed Infrastructure – S&P Global Infrastructure Index; Unlisted Real Estate: NCREIF Property Index; Listed Real Estate – FTSE EPRA/NAREIT Developed Index.
Total returns represent the annual four-quarterly rolling data from 31 March 2009 to 31 March 2023.

Historically, property has been considered a foundational asset for many institutional investors. But in light of the seismic changes occurring in commercial property, and both listed and unlisted property's weaker performance, with higher volatility than unlisted infrastructure (see Figure 2), this allows for a discussion as to whether a shift away from commercial property will see infrastructure take its place in portfolios.

The re-evaluation of infrastructure, coupled with many European countries transitioning from a legacy DB market with a limited investment horizon to one with large, dominant and cashflow positive defined contribution (DC) funds, will potentially allow investors to replicate the success of Australia's superannuation sector. The first-mover advantage associated with the strong returns of the 1990s and early 2000s could once again be available to these institutions emerging in countries, including the UK and Ireland, where semi-compulsory savings pools are about to be, or have already been, established.

These DC funds will be able to invest their beneficiaries' savings to support, and ultimately, accelerate the coming energy and net-zero transition that will require existing infrastructure to be upgraded and the construction of the next generation of infrastructure assets.

[5] 2024 commercial real estate outlook | Deloitte Insights

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