IFM Investors

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Open and closed-ended funds in infrastructure investment portfolios

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Institutional investors are increasingly allocating capital to infrastructure investments due to the stable, long-term returns they potentially offer and their ability to be a good duration match for long-term pension liabilities. Both open-ended and closed-ended fund structures can be suitable for investors, but the most appropriate structure will ultimately depend on the nature of the infrastructure investment that is being undertaken, including the specific assets in the portfolio and the investment time horizon.

We believe essential infrastructure investments (e.g. utilities, ports, airports, toll roads) with long-term, historically stable cashflows are best suited to open-ended fund structures, so the investor may realise the full potential of the assets through their life cycle. Closed-ended funds can be more appropriate for core-plus infrastructure opportunities that provide attractive returns for a finite time period and that is the only exposure the investor is seeking. Such assets include those that carry higher risk due to a complex development or construction period, or situations where they rely on new technology which is not proven. The lack of visibility on the essential nature of such assets makes it hard for investors to have a confident, 20+ year view on value and returns. A closed-ended fund enables a manager to realise the capital gains on those assets within the period in which they are expected to offer a higher risk strategy for a short-term period, before they ultimately convert to being long-term core infrastructure assets. Open-ended funds can also capture assets with a core-plus exposure over a certain period, provided the risk in the portfolio is

IFM's purpose and the alignment with infrastructure investment

IFM's purpose is to invest, protect and grow the long-term retirement savings of working people. Our strategy of long-term infrastructure investment is well suited to achieving this purpose given infrastructure has historically proven its ability to deliver long-term returns.

Our infrastructure investment strategy centres on the long-term ownership and active asset management of critical infrastructure. Investing for the long-term means addressing climate change risk, ensuring constructive labour relations, and building diverse and inclusive workplaces to create and retain value, which is also naturally aligned with the long-term expectations of the communities where we invest.

By being an active owner – usually with board representation – we have the ability to drive the business strategy within our investee companies, with the aim of generating stronger returns for our investors.

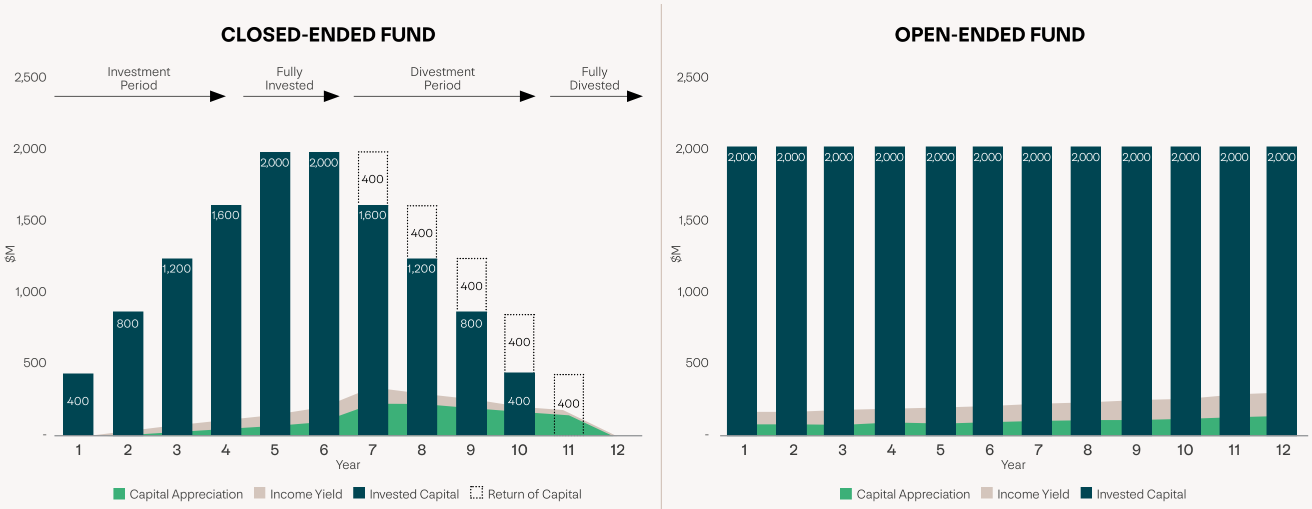
appropriately diversified and reflective of a long-term hold. This is typically reflected in target percentage or limit to core-plus exposure in strategy by the manager.

This article provides a detailed discussion of the differences between open and closed-ended infrastructure funds and outlines situations in which each structure has a role to play within an investor's overall infrastructure exposure.

Open versus closed-ended infrastructure funds

Figures 1 and 2 provide a detailed analysis of the similarities and differences between open and closed-ended funds across a range of fund characteristics.

FIGURE 1



Source: IFM Investors

Assumptions:
- Commitment of $2bn for both open and closed ended funds
- No return of capital for the open-ended fund as no divestments are assumed.

Fund structure in an historical context

The Australian infrastructure market is one of the most mature private infrastructure investment markets globally. As far back as the early 1990s, Australian pension funds had identified the benefits of matching their long-term liabilities to long-lived infrastructure investments via long-term, open-ended fund structures.

When pension fund investment in infrastructure was at a nascent stage in Europe and the US in the early 2000s, 10 to 12-year closed-ended infrastructure funds were introduced into these markets as the preferred vehicle because the closed-ended structure was familiar to investors, many of whom had experience in private equity. Investing in infrastructure was new, but the closed-ended investment vehicle was easy to understand.

Open-ended funds were a less-understood structure in private markets at this time and they added further complexity to the decisions faced by new infrastructure investors, who were already grappling with this new asset class.

Fast forward to today, and the situation is quite different – closed-ended funds are still popular but open-ended funds are becoming more common in Europe, North America and Asia as investors appreciate the potential benefits of this fund structure for realising the full potential of essential, long-term infrastructure assets. Managers and investors globally have embraced the benefits of open-ended funds and they now attract considerable funds under management.

FIGURE 2

Characteristics of open-ended and closed-ended funds

Key features	Open-ended funds	Closed-ended funds
Fund term	Evergreen, perpetual	10 to 12 years
Commitment and draw down	Investors can commit new capital through the life of the fund. Investors have the ability to manage their own allocation schedule and re-up to fund based on acquisition pipeline and performance.	Investors typically have 12-18 months to commit to a fund. Further allocations are not possible to the same fund except through the secondary market.
Investment period	Ongoing, with no deadline imposed on the manager to invest or divest, creating the opportunity to diversify across vintages and invest and divest opportunistically.	Defined investment period, typically 3-5 years to reflect the economics and market for that vintage. Divestment within the life of the fund, typically around 10 years with possible extensions depending on the term of the fund.
Investment strategy	Long-term, well suited to essential infrastructure. Manager can size fundraising to align with acquisition pipeline. Fund can grow and diversify to rebalance the portfolio over time. Manager's long-term hold is attractive to strategic co-investors and vendors who seek long-term investment and support for the asset. Exposure to an asset through the cycle, enabling managers to manage and make investments in the asset to add value over the long-term. Less pressure to divest assets in periods which are not optimal sale conditions for such assets. True match if investors have long-term liabilities.	New acquisitions must be made during the investment period reflecting a specific vintage. Shorter-term focus as manager prepares assets for sale during the life of the fund. More suited to non-core infrastructure and assets where the long-term investment case is hard to assess. Managers will seek a shorter payback period for value-add initiatives. Capital returned to investors.
Transparency	Investors know the assets they are investing in. Detailed due diligence on assets is possible.	Investors are committing to a blind pool where investments are not known up-front, except for potentially seed assets. Track record in previous funds may not reflect strategy for current fund.

FIGURE 2

Characteristics of open ended and closed ended funds (continued)

Key features	Open-ended funds	Closed-ended funds
Contributions and redemptions	Investors have influence over timing and amounts of their investment, subject to commitment and redemption policy.	Manager has control of draw down amounts over the investment period.
Valuations	Manager conducts periodic (usually quarterly) independent valuations to value the NAV of the Fund.	Interim valuations are typically conducted internally by the manager, with periodic external valuations. Valuations crystallised through sales processes.
Entry price	New investors pay NAV for existing assets.	New investors pay Cost + Roll Forward for any seed assets. Entry is restricted to usually 12 months after initial close. Units can be traded on the secondary market with pricing dependent on market conditions rather than NAV.
Distributions	Regular distributions, sometimes with the ability to reinvest distributions into the fund.	Distributions occur after the investment period.
Liquidity	Liquidity for redemptions is available from cash yield or queued capital.	Liquidity available from secondary market, distributions and asset divestment.

Source: IFM Investors

One of the key differences between these fund structures is the lifespan of the fund itself. Open-ended funds are perpetual, they remain open to new investors and existing investors can commit capital at regular intervals to be drawn as determined by the manager. As a result, investors can continue to make investments in new assets and existing portfolio companies. There is no set date at which an open-ended fund closes and returns investors' capital, but investors can redeem on request, subject to predetermined conditions.

Closed-ended funds exist for a set period of time, typically 10 to 12 years. On opening, they accept commitments from investors which are used to purchase assets for the portfolio. These assets tend to be held for 3 to 6 years and then divested, with the fund itself closing at a predetermined date and returning capital and accumulated returns to the underlying investors. We have recently seen managers try and adopt the "best of both worlds" approach with long-term closed-ended funds of 15-20 years. This does enable the manager to extract more value through management of an asset through its cycle, similar to an open-ended fund, however the liquidity to the investor remains limited, similar to a closed-ended fund.

This difference in fund lifespan is a significant determinant of the type of infrastructure assets that suit each fund structure – open-ended funds tend to favour core infrastructure assets, whilst closed-ended funds are more suited to non-core assets. These themes are explored in more detail below.

Open-ended funds are a good fit for essential, long-term infrastructure assets

Similar to "non-core" infrastructure assets, essential, long-term infrastructure assets tend to be illiquid whether they are essential or not, as they have complex structures, significant scale and occasional restrictions on their ownership due to their essential nature. They include critical assets to the economy such as utilities, ports, airports and toll roads (amongst others) that have long-term, stable cash flows. Essential, long-term assets have historically formed the basis of our infrastructure investments at IFM, and we have always believed that they are particularly well suited to open-ended fund structures, so that their full return potential can be realised by the manager through the asset's life cycle. As competition for essential, long-term assets increases and market dynamics shift, holding an asset over the market's cycle provides managers the ability to realise the full potential of the asset value for investors by actively maximising the opportunities through the cycle that are unique to that asset. Such active management of the infrastructure assets can be via timely capital improvement plans and other long-term business planning, which serves to add further value to these assets. The open-ended nature also allows the manager to time the asset's exit to maximise the value received from the sale of that asset.

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The key reasons include:

- **Asset-liability matching** – The perpetual nature of open-ended funds allows for long-term investment in core infrastructure assets which have reliable long-term return potential. This can be attractive to pension funds, which by their nature have long-term liabilities.

- **Visibility** – Investors can make an informed investment decision on an established portfolio of assets held in an open-ended fund to determine the risk profile and potential returns of the portfolio.

- **Broad diversification** – Open-ended funds can accumulate assets over a long period of time, providing diversification across sectors, asset age and risk profiles, which can help manage long-term investment risks. The ability to rebalance the portfolio in response to market conditions over time is also enhanced.

- **Opportunities to expand/improve existing assets and participate in growth opportunities** – Open-ended funds can take part in the expansion and/or improvement of existing essential, long-term infrastructure assets in the portfolio as the investment period is usually very long. This can provide attractive returns with lower transaction risk because such opportunities do not usually involve a competitive process and can be priced accordingly. The box on the next page provides an example of a successful expansion and asset improvement opportunity that was implemented through the Manchester Airport Transformation Program.

- **No pressure to divest** – Open-ended funds do not have to divest assets at a predetermined date. Instead, they can hold assets indefinitely if the returns are proving attractive, or choose to sell if the market price of an asset moves to a level where selling would be advantageous for the underlying investors. Many open-ended fund managers assess the market for their assets quite regularly to determine when to realise value.

- **Access to deal flow** – Due to the open-ended fund structure and long-term investment horizon, an established investor like IFM is often viewed as a preferred partner as our long-term strategic view tends to resonate with vendors selling down assets, or those concerned with ongoing operations as a future client. This is also important in the privatisation of critical community assets. A favourable reputation can potentially provide better access to new deals that enter the market.

- **Lower friction costs** – Investors can hold an asset through the cycle, avoiding the transaction costs associated with moving from a closed-ended fund to a successor fund.[1] The transfer of an asset to a successor fund, or the purchase of a replacement asset, both involve substantial transaction costs for divestment and purchase and can also generate a conflict of interest between the vending and purchasing fund investors.

Manchester Airport Transformation Program

IFM Investors (IFM) owns 35.5% of Manchester Airport Group along with Manchester City Council (35.5%) and nine other Greater Manchester local authorities (29%). With a portfolio comprising Manchester, Stansted and East Midlands Airports, the Group is one of the United Kingdom's largest airport operators. Since IFM invested in early 2013, there has been significant capital investment in the asset, including the £1bn Manchester Airport Transformation Program. As a result of a carbon reduction program endorsed by IFM and other shareholders, all three airports are now carbon neutral, with all energy needs met via renewable sources. This efficiency gain has translated directly into improved financial performance for investors. The Group has also made substantial investments in the Stansted Airport College, which trains airport industry workers of the future. This initiative builds public trust and contributes to economic prosperity at the individual, community and industry levels; outcomes that better enable IFM to protect and grow the long-term retirements of working people worldwide.

Manchester Airport

[1] This is generally required if an investor wants to hold assets from a closed-ended fund for an extended period.

In summary, open-ended fund structures can accommodate the long-term nature of essential infrastructure assets and avoid unnecessary asset turnover that can be costly and disruptive for investors. Open-ended fund structures can also enable fund managers, like IFM Investors, to form long-term partnerships with management and other stakeholders employed by portfolio companies. This can contribute positively to the management of the assets, help drive capital expenditure programs that are implemented with a long-term view, and create value for existing investors.

Closed-ended funds suit newly emerging infrastructure sectors

The infrastructure market is changing rapidly in response to a number of broad structural themes such as rapid technological advancements and the global shift towards a net zero world. This is creating opportunities to invest in newly emerging infrastructure assets that tend to have non-core characteristics such as:

- relatively high return expectations, that are likely to only last for a short period of time, due to complex development or construction periods or the development of unproven technology
- the provision of services that are based on innovative and/or rapidly evolving technology or services that are not yet proven to be essential to society, and have a private equity element that is not considered core infrastructure
- some level of stranded asset risk in the future (end of life core infrastructure).

The challenge in investing in these types of assets with a 20+ year "core" infrastructure view include:

- their essentiality tends to be unproven or not yet achieved
- they are subject to significant disruption risks
- they have more competitive operating environments.

These factors ultimately make such investments very difficult to price. Closed-ended funds are better suited to these types of assets as they can potentially take advantage of the attractive returns on offer by investing over a shorter, finite time horizon.

A good example of this is to consider the evolution of the data centre sector in recent years. When data centres first emerged, they were viewed as quite innovative infrastructure assets, but their essentiality was not proven, and neither was the technology or the data warehousing demand projections on which their investment thesis was based. They offered the potential for relatively high returns but were not viewed as core infrastructure assets. At that time, they were better suited to closed-ended, shorter-term investment funds that were able to take on the risks involved. But in recent years, the essentiality of data centres has been proven as large-scale data storage has become crucial to the economy and demand for capacity is growing rapidly. The market for these assets has gradually matured and they are starting to be viewed by many investors as "core" infrastructure assets that have a place in long-term, open-ended infrastructure funds.

Portfolio implications

The debate around open and closed-ended infrastructure funds is not new but it has evolved considerably in recent years, and we believe both structures have a place within the market. The recent trend towards continuation funds on closed-ended vehicles and the opening of longer-term closed-ended funds suggests increasing investor demand and manager preference for long term investments in core infrastructure.

Open-ended fund structures are well suited to realising the long-term value generated by essential, long-term infrastructure investments, for both investors and the communities they serve. In addition to appropriately matching long-lived infrastructure investments to pension investors' long-term funding obligations, open-ended funds provide investors with vintage diversification, an existing portfolio of investments, growth opportunities through follow-on investments, and independence to manage their own allocation profile and distributions.

But there can be a place for closed-ended funds in an overall portfolio allocation to infrastructure. Closed-ended funds can provide attractive investment opportunities for non-core infrastructure assets and exposure to the higher risk sectors within the asset class where complex development, construction and technological change are key factors driving the adoption of a shorter investment horizon. They also provide investors with an opportunity to gain exposure to assets that will undergo meaningful repositioning over a relatively shorter time period.

From a portfolio construction perspective, investors may find it beneficial to hold their essential, long-term infrastructure investment in an open-ended fund, while supplementing returns with exposure to specific non-core infrastructure assets in shorter-term, closed-ended structures.

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