Bricks and water

***Peter Morris** examines how UK infrastructure assets are managed and funded as their appeal grows among investors and pension groups*

Infrastructure – not usually a word to set the pulse racing – is becoming a hot topic. Labour politicians recently suggested that they would like to renationalise whole industries in the UK, starting with water. Whether or not that is the right solution, it seems increasingly clear that financiers have, in some cases, been able to "game" the system. Diane Coyle, professor of economics at Manchester University, recently wrote in the *Financial Times* that "regulators…need to be less naïve about financial engineering".

This article addresses a narrower question. Given that many infrastructure assets remain in private hands, what is the best way for them to be funded and managed? One way is via conventional quoted companies, such as the UK's Severn Trent water company. But the past couple of decades have seen explosive growth among specialist infrastructure managers. Global Infrastructure Partners was only founded in 2006 but the $15.8bn that its latest fund raised is similar to the amounts being raised by private equity firms that have been around for decades. Many investment banks

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and private equity firms now have their own infrastructure management arms. Some large pension funds are also investing directly.

Investing in infrastructure through specialist funds shares features with generic private equity: for example, fund and fee structures, the use of high levels of debt, and opacity. In November 2015, a McKinsey report observed: "The infrastructure-finance market is plagued by a lack of information." Is this kind of specialist management the right way for pension funds to invest in infrastructure assets?

Here you might pose a simple boundary question: what counts as "infrastructure"? According to the Oxford English Dictionary, infrastructure is "the basic physical and organisational structures and facilities (eg buildings, roads, power supplies) needed for the operation of a society or enterprise". Most people would find it easy to agree that a UK water company qualifies as an infrastructure investment. Society requires its services, it has a natural monopoly and it is highly regulated. But what happens when you start to edge away from the centre? Does a chain of crematoria qualify as "infrastructure"? A waste management company? A directory services (that is, yellow pages) company? Fund managers who describe themselves as infrastructure specialists have invested pension fund cash in each of the last three. In the case of the last two, the consequences were big losses for investors (eg Biffa in waste management; in directory services, a long list that includes World Directories).

The opaque language that is used reveals confusion over this question. Some infrastructure managers use the words "core" and "core-plus" to distinguish between clear and more marginal infrastructure plays, although no one draws the boundary in the same place. Others use the word "adjacent" to denote more marginal sectors. But here, too, boundaries are slippery. What is clear is that pension funds may find they have invested in something more racy than the word "infrastructure" suggests.

A second question about infrastructure investing picks up one of its similarities to private equity – namely, financial engineering. Specialist infrastructure investors, like their generalist private equity peers, use higher than average levels of debt. This is perfectly legal. Arguably, some regulatory frameworks, including the one that Ofwat set up for the UK water industry, actually encourage high levels of debt. But, just as in the case of private equity, such financial engineering has nothing to do with running companies better. "Why would I invest in an asset class that just consists of taking the most stable assets and leveraging them up as far as possible?" asks one endowment manager.

Another question involves time frames. A typical defined benefit pension fund has liabilities that stretch out for decades and would ideally like to match them with assets of similar duration. Many infrastructure assets meet that test. But the way infrastructure managers typically invest in them does not. A typical infrastructure fund – modelled after private equity – has had a life of 10 years, perhaps extendible for a brief period. Compared with the life of a pension fund, that is the blink of an eye and holding periods can be shorter still. For example, Morgan Stanley Infrastructure and Infracapital, part of M&G, bought Affinity Water from Veolia

for £1.3bn in 2012. In May 2017, it sold it for £1.6bn. It is hard to see how this five-year holding period fits with the long-term pension fund needs that the sector talks about.

Finally, operational expertise is a key selling point for infrastructure managers, just as it is for their private equity peers. The sector stresses the skill that specialists bring to the management of assets that are so vital to society in general. By implication, this helps to justify the high fees that can be involved. But, as in private equity, one should probably ask how much more skilful these specialists can really be.

The UK water industry provides a handy controlled experiment. Four of the larger companies are owned by infrastructure funds, while another four are either quoted (three) or independent non-profits (Welsh Water). A quick

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financial analysis suggests that over the past five to 10 years the specialist infrastructure managers have generated essentially the same gross return on capital (that is, before financial engineering) as their peers at quoted companies.

This should not really come as a surprise. The UK water sector is highly regulated: that is what makes it an attractive infrastructure investment. But regulation also limits the ability of any one management team significantly to out- (or under-) perform others. That creates *prima facie* doubts about how real the extra operating skill can be. The actual financial results in UK water appear to confirm these doubts.

These four issues reflect several factors, especially the one that Eugene Zhuchenko, executive director of the Long-Term Infrastructure Investors Association (LTIIA), points out: "Although it has grown fast, infrastructure is still quite a young asset class." Founded in 2014, the LTIIA aims to help investors get the same kind of transparency that they receive in other asset classes. "Investors come into infrastructure to stay," Zhuchenko points out, "not to leave. That means they're looking for new ways to invest: for example, separate accounts and longer time horizons."

The UK's Pensions Infrastructure Platform represents one such initiative: it offers a fund with a longer time frame (25 years) and a flat fee structure with no carried interest component.

Infrastructure matters to everyone. The way it is owned and run matters, especially to the rising number of pension scheme members whose savings are being invested in it. Pension funds and other investors need to ensure that, as the infrastructure sector matures, there is an appropriate split of risk and reward between managers and asset owners.

It can be done. "Our Multi-Strategy Infrastructure Fund (MSIF) aims to give pension funds what they really want when they invest in infrastructure assets," says Mike Weston, chief executive of the Pensions Infrastructure Platform, set up four years ago by pension funds for pension funds.

"Since pension funds want long-term exposure, MSIF has a 25-year life," he says. "A buy and hold strategy does not need a fund manager incentivised for capital gains, so the fund's fee structure is a flat 50 basis points per annum without any carried interest. Commitments to the fund are now over £600m." ■

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