KEYNOTE INTERVIEW

Risk's rising profile

Infrastructure investors' attitudes to risk have evolved significantly but there is still more work to be done, says FIRSTavenue's head of US project management Chris Tehranian

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Q How have LP attitudes towards risk categorisation in the infrastructure industry evolved?

When I first started out investing in infrastructure back in 2007, there was no distinction made around risk profile. All the funds being raised in infrastructure distinguished themselves more by strategy and geography than by overall level of risk. An investor might have assumed they were de-risking their portfolio, but in some cases were actually taking on more of a private equity risk profile with increased market and volume risk. This was evidenced when the global financial crisis brought with it drops in the global market, commodity prices, as well as utilisation and pressure on leverage. That hit some funds' performance harder than others. The industry began to ask itself if infrastructure was inherently riskier than previously thought, or whether risk, in fact, stems from strategy – the amount of leverage being employed, for example, or the growth expectations. As a result, infrastructure adopted a profile system similar to the real estate risk classifications of core, valued-add and opportunistic. That has continued to develop with the emergence of further classifications including super core, core-plus and infrastructure services.

This has been an important evolution for investors. After all, a power plant may be a regulated utility or it may be a greenfield merchant project. With the former, you take limited utilisation or pricing risk. With the latter, you take both, and possibly construction risk too. These current infrastructure risk categorisations reflect, fundamentally, where the asset is in the investment lifecycle. But these categorisations can change over time. A value-added asset can move to core and later become opportunistic depending on the life of contracts, regulatory regimes, technological changes and capital expenditure needs.

10-15%

Net returns typically targeted by US infrastructure investors

The challenge for both GPs and LPs, however, is that there is no commonality in these risk distinctions beyond basic return ranges and basic characteristics. Small differences in IRR can involve a large distinction in risk profile and there are very few benchmarks available to help differentiate. This is complicated by the fact that IRRs are time-weighted, so a hold period becomes just as important. As it stands, these risk profiles are primarily qualitative measures

for risk based on investments' underlying characteristics.

The issue is that the further you go up the risk curve, the fewer of the foundational infrastructure characteristics are likely to be present in an investment. It's hard to get a core investment that has a private equity return profile. And again, the challenge is with effective benchmarking. Whether you're looking to benchmark against an absolute return target – consumer price inflation plus 4 percent, for example – or against a mix of listed infrastructure equity indices or peer-ranking services, none of these make a distinction based on risk profile.

If you're investing in core and generating a consistent 8-9 percent net return, comparisons with value-added or opportunistic approaches can be misplaced. You're always going to be behind your benchmark even though your expectations might be met. Additional challenges come when an investment's return materially exceeds or falls short of these expectations. Did the manager outperform or underperform? Or was the investment miscategorised?

I'm optimistic that accurate benchmarking will help provide more clarity on some of these nuances, but interpretation will still be key because most infrastructure funds in the market might actually be a mix of risk profiles. Because of this, more benchmarking service providers are looking through fund portfolios and are focusing on the underlying assets. This seems to be gaining momentum as more investors are requiring GPs to disclose underlying portfolio information to the service providers on a regular basis. Transparency and industry adoption will be key here.

Q What are your predictions for the infrastructure funds industry?
From being an investor, and now an adviser, it's been wonderful to see the growth in the infrastructure universe over the past decade. I welcome the proliferation of managers, vehicles and ideas. I like to see differentiated approaches and specialist engagement. I also think investors in infrastructure are becoming more sophisticated. We're no longer asking 'why infrastructure?' The conversation is now more around portfolio construction and allocation.

My hope is the asset class continues to mature and innovate. I can honestly predict that we'll continue to debate relative valuations, fund structures, benchmarks, optimal portfolio construction and risk/return profiles well into the next decade. The good thing is that infrastructure will continue to be a key component of investors' overall portfolios.

Q Our survey results show that a large contingent of investors are still approaching risk categorisation opportunistically. Does that surprise you?
An investor's approach to risk depends on the reason it is investing in the asset class in the first place. Investors like infrastructure because it involves monopolistic and essential assets, features uncorrelated investments with downside protection in terms of contracts and regulatory environments, has real asset features such as inflation linkage, and offers cash yield opportunities. This all provides a good fit for asset liability matching and means infrastructure can complement or provide a substitute for riskier or more correlated asset classes, as well as for fixed income.

Investors can also customise their approach in infrastructure investing. If an investor wants current income and longer durations, or if it prefers liquidity and higher returns, there are options available. I also believe that investors, when viewing portfolio construction, don't need to fill one allocation before they move on to the next risk-profile allocation. It makes sense that investors choose the work plan that suits them based on capital deployment, options in the market and overall market conditions.

What I hear most in the market is how investors are looking at and reviewing their strategy as to whether they will reinvest with existing managers versus investing in new opportunities. As more investor portfolios mature and with overall liquidity being low, coupled with a more rapid deployment pace by most managers, these decisions are even more challenging.

Q Is there a danger, therefore, that in this low interest-rate environment, investors are chasing returns without fully appreciating the associated risk?
Investors tend to have allocation policies around their exposures to core and value-add opportunities. Most of the market, in terms of funds in the market, are targeting these types of risk profiles. There are regional differences in terms of return expectations, but I wouldn't say that investors are chasing returns or increasing their expectations compared with the past few

years. When I talk to US investors, a large majority are looking for somewhere between 10 and 15 percent net returns. That's going to be difficult to achieve with a core, or even core-plus, strategy. Value-add to opportunistic become the sweet spot based on return expectations. Conversations with investors in other geographies tend to target 8-12 percent returns, with a focus on current income and duration, which can open up the infrastructure opportunity set.

Based on these expectations and allocation preferences, the real question is whether managers – not necessarily investors – will be chasing returns outside their associated risk profiles. I'm sure there are many opinions on this – 2019 was a strong fundraising year, further compounding the issue of dry powder or uncommitted capital in the market. Can this capital be invested in a prudent manner and within a reasonable timeline? Infrastructure equity and debt offer a compelling return opportunity set in this low interest-rate environment, and it is one of the reasons we've seen the rise in infrastructure allocations across investors over the past decade.

"Small differences in IRR currently drive meaningful distinctions in risk profile and there are little to no benchmarks out there to help differentiate actual risk/return profiles"

Q Is appetite for core infrastructure waning?

Based on the current fundraising market, I don't believe so, but access for most investors to this segment is relatively limited. It does feel like 2019 was the year of the super core vehicles. There does seem to be a concern that returns in this segment will continue to compress, but we continue to see meaningful capital flows to the area.

Interestingly, investors targeting core opportunities have been looking at more innovative vehicles and focusing on duration and cash income. Traditional private equity structures are not necessarily the best option for investors. Rather, investors are deploying capital to open-ended funds, SMEs, club deals and co-investments. This can also help manage an investor's portfolio construction, deployment timing and the overall impact of fees.

Q How is the open- versus closed-end fund debate playing out in infrastructure, and what innovation are you seeing in terms of fund structures?

Closed-end funds are the most prevalent and will continue to be. There were approximately 250 managers in the market in 2019 and nearly all of these were closed-end. However, the industry is starting to challenge the idea that we need to use the traditional commingled private equity structure, especially for core infrastructure opportunities. As discussed, investors are looking past traditional closed-end structures in order to manage their duration, liquidity needs, deployment pace, investment discretion and portfolio construction. Innovation has also been part of this with creative extension vehicles and even GP restructurings, which assist in facilitating the transition of investments to a next generation of owner.

Certainly, there is more innovation to come around fund structuring, and alignment and governance considerations will continue to drive this innovative thinking.

Q As value-add and opportunistic strategies push the boundaries of what is defined as infrastructure, what does the emergence of new subsectors mean for the risk investors are taking on?

The expansion of infrastructure's parameters is simply a feature of the asset class's maturation. In my consulting days, I once used a Venn diagram that categorized sector and subsector overlap across natural resources, real estate and infrastructure. Infrastructure has gradually absorbed certain sectors that would previously have been in other asset classes.

Definitions will continue to evolve. After all, we have seen strategy shift discussions before around data centres, ports, rolling stock and others. I'm sure there will be further lessons learned in the market.

There does seem to be a rise in the number of opportunistic strategies coming to the market in 2020. These tend to involve more of a private equity approach to infrastructure and focus on growth equity strategies or on non-traditional sectors that might share infrastructure characteristics but aren't necessarily essential or monopolistic assets. I'm not sure this will push any boundaries, but it does show a differentiated approach and options for investors in their portfolio construction.

I'm more excited about the growth and mix of specialists, both by sector and geographic focus, available in the market today versus 10 years ago. Investors have more options and can define in most cases which new sectors they would like exposure to. ■