

The Growth of Infrastructure Investments by Institutions

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Infrastructure, physical assets like airports, bridges, and railroads is a fairly new asset class that has emerged over the past few years. Institutional investors such as mutual funds and pensions have been adding this asset class to their portfolios slowly, but increasingly. This paper examines the growth of these investments in institutional portfolios over the past several years.

INFRASTRUCTURE DEFINED

In the United States, it has become common for politicians, economists, and others to call for increased spending on infrastructure. A strong infrastructure is required for the foundation of a sound economy. Without, airports, rails, bridges, and other key elements of infrastructure a country's economy would stall.

Infrastructure assets provide essential services to society. Services that are critical to daily life and daily commerce. They are generally thought of in terms of their physical characteristics. It's easy to imagine some of the modern-day marvels we see – bridges, dams, and levees, for example. The investing community divides infrastructure into two categories: economic and social. Economic infrastructure assets are things like bridges, roads, seaports, and airports. They can also be in industries like electricity and waste water treatment. And an increasingly important element to our economy and our daily lives – telecommunications. Social infrastructure assets include hospitals, schools, and prisons.

Economic infrastructure assets can be either regulated or unregulated. Some create revenue through usage fees. A prime example is the toll revenue from a toll road. Some economic infrastructure assets, like cell phone towers, may receive revenue from contracts with service providers.

The following table shows the diversity of infrastructure investments across industry sector.

TABLE 1

Economic			Social
<u>Communications</u>	<u>Energy</u>	<u>Transportation</u>	
Broadcast antennae	Electricity	Airports	Courthouse
Fiber options	Gas/Oil	Bridges	Hospital
Cell phone towers	Hydro power	Roads	Prison

ORIGINS

At the beginning of the 1980s, the British government owned many of its country's major industries. This included steel production, the oil industry, airlines, automobile manufacturers and other industries. During the 1980s, the British government began selling off these assets. The privatization of these industries continued and by the end of the decade, virtually all of them had been privatized.

In addition to full-on privatization, the British government also began a series of public-private partnerships. The objective of these partnerships was to create an incentive for the private sector to build and operate some of the functions of infrastructure that had been exclusively borne by the government. Public-private partnerships have remained popular throughout Europe and in other parts of the world. The trend has been slow to catch on in the United States where public infrastructure projects are still financed primarily by taxes or the issuing of municipal bonds.

Infrastructure investments, by their very nature – roads, bridges, airports, and telecommunications – are huge. On the other hand, they offer returns almost indefinitely or at least for the very long term. This, in part, has made them attractive investments for long-term targeted funds such as pensions and other retirement funds, the bailiwick of institutions.

Countries outside the United States continue to lead the way in these infrastructure investment opportunities. Former socialist countries continue, in general, on a path of privatization. Many major European infrastructure industries are publicly traded companies. Deutsche Bahn, the German national rail company, is a prime example. Many European airports are structured similarly. Some estimates put the total infrastructure market at \$20 trillion.¹

HOW INFRASTRUCTURE ASSETS WORK

Infrastructure investments are called greenfield when they require new construction. Brownfield investments are mature, well-established facilities with stable cash flows. The transactions of infrastructure generally fall into one of three types: privatization, private transactions, and public-private partnerships.

Privatization is when the government sells its own infrastructure assets to a private investor. Private transactions are simply when two private sector parties trade an infrastructure asset through a sale or other transaction. Finally, public-private partnerships are when the government attempts to get the financing for an infrastructure asset from the private sector. And then may also look to the private sector to operate and maintain the investment.

Public-private partnerships appear to be gaining in importance among infrastructure investments. An example of such a partnership in the United States is when the City of Chicago contracted with Cintra Corporation to run the operations of the Chicago Skyway. The City of Chicago retains ownership of the underlying asset, but Cintra will be responsible for maintenance and other expenses. Of course, Cintra will retain the majority of the revenue from tolls and other sales.

Institutional investors gain access to infrastructure investments in a number of ways:

Open-end Funds

This is an investment vehicle where several different investors pool their money into a fund.

Limited Partnerships (Closed-end funds)

These are similar to open-end funds except that they have a fixed maturity date when the investment ends.

Direct Investment

This is less common, but there are times where a private firm may venture to build the resource itself. And then charge a usage fee. An example - Municipality owns land. Private Company builds public golf

course on Municipal land. Private company pays Municipality a lease payment, but receives revenue from golf course fees. In this case, the Private company has borne virtually all of the risk of the project.

NEED FOR INFRASTRUCTURE

Infrastructure is essential to ensure the daily free flow of goods and commerce. It also contributes to the quality of life and well-being of citizens. As the economies of the world continue to develop, enormous investments in things like rail, airports, schools, water delivery, and other essential assets are needed. This growth provides an ample opportunity for the private sector to invest. Some estimates put the additional amount spent on inventory in the next 20 years at nearly \$100 trillion.²

The United States is among the countries requiring significant additional investment in infrastructure assets. In 2009, the American Society of Civil Engineers gave the condition of the United States infrastructure near failing grades across the board. This included the condition of existing infrastructure as well as the projected future needs.³

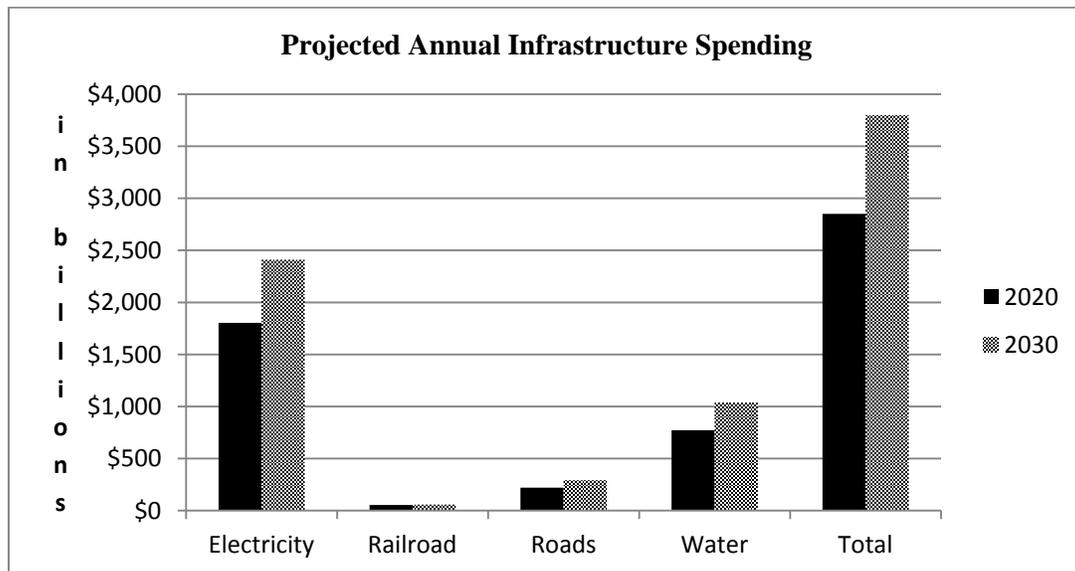
TABLE 2

Sector (not all sectors/grades shown)	ASCE Report Card 2009
Bridges	C
Dams	D
Levees	D-
Roads	D-
Overall	D

While governments recognize the need for increase infrastructure spending, they are hamstrung with pressures to reduce taxes, spending and debt. As a result, governments have been looking to the private sector to ultimately finance this spending. This again, creates substantial long-term investing opportunities.

The chart below shows the expected annual required expenditure on a few infrastructure categories.

CHART 1



PERFORMANCE OF INFRASTRUCTURE INVESTMENTS

Institutional firms generally measure their investment performance against a benchmark. A large-cap stock portfolio might be measured against the S&P 500 index. Investments in small cap stocks might be measured against the Wilshire 5000. A problem institutions face when considering infrastructure investments is choosing an appropriate benchmark. Because of the diversity of these investments, there is no industry standard benchmark. It can also be hard to obtain information about the performance of infrastructure investments since they are not generally publicly traded.

A measure that is sometimes used as a benchmark for infrastructure investments is the Dow Jones Brookfield index.

WHY INFRASTRUCTURE?

If we agree to use the DJB index as our proxy for the performance of infrastructure investments, we see that over the past 8 years the average annual return has been 14.87%. This compares to only 8.03% for the Wilshire index. This performance shows that in addition to simply diversifying a portfolio, adding infrastructure to a portfolio can actually increase its value.

In addition to numerical performance, there are other solid reasons to invest in infrastructure assets. First, the glaring need worldwide for infrastructure projects. Dams in China, bridges in Vietnam, railroads between Minneapolis and Chicago. The list goes on. There should continue to be ample opportunity.

Second, institutional investors are by their very nature long-term investors. Infrastructure, by its nature is a long-term investment. It's a perfect match.

CONCLUSION

Infrastructure investments are becoming more and more commonplace in the portfolios of institutional investors. They offer diversification, performance, and huge potential growth opportunities. They are attractive to institutions because of their focus on the long-term. With the explosion of burgeoning economies all over the world and the addition of more established economies needing to rebuild, infrastructure investments are likely here to stay for a long time to come. Like the structures themselves.

NOTES/REFERENCES

<http://www.econlib.org/library/End/Privatization.html>

Organization of Economic Co-operation and Development (OECD), "Infrastructure to 2030", January 2008.

American Society of Civil Engineers 2009 Report Card.