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Infrastructure and local authority pension schemes – beyond philosophical mysticism

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Cognisant of the approaching deadline for pools to submit proposals and with the ongoing political pressure on local government pension schemes to invest in infrastructure it is a pertinent time to re-examine the issue.

Firstly, like any other asset class, trustees need to be assured that infrastructure offers economic value to underlying members. In this context it is worth noting that **infrastructure is not an asset class**. The capital structure of project finance comprises equity, debt and mezzanine debt, all of which have distinct characteristics and thus fulfil different functions with respect to investment objectives. LGPS clients seeking to potentially diversify their growth portfolios might consider equity or mezzanine debt, those wishing to enhance their cash-flow matching portfolios might consider senior infrastructure debt.

Senior infrastructure debt has the potential to provide stable, sustainable cash-flows. As with any asset class definition creep can see financial structures and underlying assets that ought not to be considered, but core infrastructure, as evidenced by Moody's, has an **attractive credit profi**le. Investment grade infrastructure assets have lower levels of default and higher recovery rates than equivalently rated corporate bonds.

Primary infrastructure debt transactions (i.e. transactions that are privately originated and structured) also have an **attractive return profile**. Spreads of 200bps over mid-swaps can be attained which has the benefit of generating positive real returns within matching portfolios. Commentary on valuations and pricing for the asset class usually focus on public utility bonds or infrastructure equity since there is a lack of visibility over the prices attained for private placements.

Given typical leverage levels applied to infrastructure finance (e.g. 85:15) the **quantum of opportunity** for investors to invest is far higher for senior debt than it is for equity. Furthermore, given the barriers to entry to project finance (discussed later) there are many more competitors within the infrastructure equity sector than for debt.

The next question for LGPS clients is, **how do I access infrastructure debt transactions**? The Joint Working Group of Local Authorities document 'Findings of Project Pool', published in January 2016[1], proposes a number of potential routes to investment. These recommendations range from creating several regional hubs, out-sourcing to asset managers or creating a national pool. The document finds that creating a national

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[1] http://www.lgpsboard.org/images/Consultations/160122_Findings_of_Project_POOL_FINAL.pdf

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infrastructure capability or multiple Multi-Asset-Pools (MAP) would be the most efficient means of facilitating infrastructure investment that would halve the management fees currently encountered in standard primary investment with a fund manager.

As the report focuses exclusively on infrastructure equity the conclusions that are drawn with respect to current **fees** and potential cost-savings of creating a national direct pooling structure for LGPS clients are inflated. Fees for infrastructure equity, whether direct or through pooled funds of funds, are of an order of magnitude higher than those associated with infrastructure debt investments. Suggesting that cost-savings of £13.5m p.a. could be attained over 10-years is therefore misleading when considering senior infrastructure debt.

The report also highlights that there are possible issues with implementing such a structure, including:

- Specialist resourcing would be required.
- Sufficient capacity needs to be attained.
- Two or more centres of excellence may bid on the same assets.
- Limited track-record.

Even if the potential fee savings could be costed properly and proven from this model there are other practical issues that will be potential obstacles.

- The time (and associated costs) it would take to build such a framework.
- Legal costs that would otherwise be borne by co-investors would be exclusively borne by LGPS clients.
- Cost of sourcing, origination and due diligence is borne by LGPS clients under this structure compared with direct investment through an asset manager.
- Lack of credit-ratings.

As with the debate on the economic viability of the asset class, it is not obvious that infrastructure debt should be treated any differently to other asset classes. If LGPS pools feel they have the capability to invest directly in private placements there is no impediment to this. If LGPS pools feel they lack the expertise required it is not immediately apparent that creating MAP structures will generate cost savings or lead to the most advantageous outcome for members.

The **criteria for selection** (or creation) of a team to offer direct private placements should thus be the same as that applied to any other asset class. Namely in selecting the right partner LGPS pools might consider the following questions:

- What is 'the manager's' definition of infrastructure?
- Will the manager focus on greenfield, brownfield, primary or secondary assets?
- What is the source of the underlying revenue?
- Are investments fixed rate, floating rate or index linked?
- What resources are available to originate private placements?
- What resources are available to structure and monitor transactions?
- Are transactions investment grade?
- Are transactions externally verified by a ratings agency?
- What is the team's track-record of origination?
- What is the team's track record in terms of default driven losses?
- What is the team's track record of remediation in the event of default?
- What pricing has been attained relative to public markets?
- Will pricing discipline be maintained if the market becomes over-heated?

- Does the manager target equity, debt or a blend of both?
- What aggregator vehicles/mechanisms are available?
- Will the manager co-invest?
- What are the fees?

The economic argument for infrastructure debt is fundamentally sound and not at odds with the fiduciary duty of pension fund trustees despite the political pressure that is being applied to LGPS schemes. Infrastructure finance is complex, but the routes to market exist for LGPS clients to access the asset class. Through aggregation and regional pooling LGPS clients will benefit from economies of scale and will be able to source competitive fee schedules from asset managers as has been demonstrated already across other asset classes.

In this context it is evident that LGPS schemes need not construct new and complex arrangements in order to access senior infrastructure debt transactions in the UK. The vehicles and co-investment opportunities exist, the pipeline of opportunity is growing and financial repression looks set to continue. Far from feeling politically pressured to invest, LGPS clients could consider the economic merits of infrastructure debt as a matching asset and select a manager accordingly.

For more information

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