Infrastructure Assets
Beware of falling discount rates

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Prices for infrastructure assets are rising, and we expect that this trend will continue for some time. Gradually declining discount rates will reduce the first-mover advantage through time. As the asset class matures, a stabilised return and yield level will be achieved. UK pension schemes will need to revise their expectations for infrastructure assets accordingly.

In this article, we describe some of the reasons behind this trend and suggest ways in which pension funds can ensure that their portfolios remain on target.

The demand from pension funds

Many long-term institutional investors are attracted to infrastructure investments, focusing mainly on core strategies. Core infrastructure (see the definition in the side box) has proved attractive to investors because of its prudent leverage levels and stable cash flows. For example, asset-level revenue performance was stable during the Great Recession with virtually no impact on regulated utilities and only short-lived declines in transportation volumes.

For most of these investors, their stated target allocations are consistently above the actual allocations to the asset class. We estimate that the average actual allocation to infrastructure assets among long-term institutional investors is less than 3%, while their targets are in the 5-10% range.

The risks inherent in infrastructure investing help explain the gap. Successful infrastructure investing calls for an understanding of local political and business dynamics, and of regional and global economic cycles. More importantly, as infrastructure assets are essential to the wellbeing of the local economies they serve, local stakeholders prefer the investor to have a long time horizon and continue investing in the asset to improve service quality.

DIFFERENT TYPES OF INFRASTRUCTURE INVESTMENTS

Infrastructure assets tend to meet the needs of long-term institutional investors, and these investors have raised their target allocations to this relatively recent asset class over the past few years. The challenge is that infrastructure offers a truly wide range in the risk-return spectrum, and the definitions and classification methods in infrastructure are not settled, largely because of the unavailability of systematic and reliable data.

The failure to differentiate among different types of infrastructure investments, ranging from core to opportunistic, leads to inefficient outcomes for investors, as well as for the public. We define core infrastructure by the main observable financial characteristic: an infrastructure investment is “core” if it produces a stable cash flow stream, which is forecastable for at least a decade with a low margin of error. Such an investment will have a prudent leverage strategy and be based on an asset that is mature (beyond its demand ramp-up phase), is located in a transparent and consistent regulatory environment with an existing track record, has revenues that are determined by long-term contracts, and provides essential services to the community with low income and price elasticity of demand.

The usual wishlist associated with infrastructure investments—characteristics such as stable yield, recession resilience, inflation protection and diversification benefits—can effectively be provided only by core infrastructure investments.

DEFINING INFRASTRUCTURE INVESTMENT STRATEGIES

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<tr>
<th>CORE</th>
<th>VALUE-ADDED</th>
<th>OPPORTUNISTIC</th>
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| Investments with forecastable cash flows for a decade or more  
*For example*, long-term contracted power, mature regulated utility, mature transportation asset | Investments that are exposed to market price risks and/or require improvements and stabilisation  
*For example*, short-term contracted power, transportation asset with short history | Investments taking advantage of market dynamics, with significant demand risks  
*For example*, un-contracted/merchant power, transportation asset with no history |
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Rising prices and falling yields

The high demand from institutional investors for infrastructure assets and prevailing low bond yields have combined to cause infrastructure asset prices to increase steadily since 2010. According to our estimates, the average valuation discount rate for core infrastructure investments has declined on average by approximately 300 to 350 basis points from 2010 to 2015. Assuming steady cash flows and leverage levels, such a decline in discount rates translates to an average price increase or capital appreciation of approximately 30-40%. This capital appreciation, combined with the relatively higher yield on core infrastructure investments, which averages around 5-7%, means total returns have largely kept pace with equity markets between 2010 and mid-2015. However, the returns on infrastructure are much less volatile: the summer/autumn 2015 correction in the equity markets once again demonstrated the diversification benefits of core infrastructure assets.

Outlook for infrastructure assets

For an asset-only investor with no liabilities to consider, this steady decline in discount rates implies declining expected returns for core infrastructure investments. Government bond yields of comparable duration have declined by 200 to 250 basis points since 2010, lowering the cost of debt and hence the cost of equity across the spectrum.

For pension fund trustees, what matters is the gap between assets and liabilities. From this perspective, discount rates have broadly fallen in line with liabilities, and the gap between core infrastructure discount rates and government bond yields remains broadly constant. Given that interest rates are at or close to their record lows, this gap is beneficial to pension portfolios concerned with matching liabilities. Over the coming years, an end to or a reversal of this trend is expected to push core infrastructure discount rates higher eventually, though continuing demand may offset this reversal.

We forecast a low-growth, low-inflation and low-interest rate environment in the long term. Infrastructure assets, when acquired with prudent debt levels, can provide downside protection and readily measurable cash flows. The high yield these investments provide relative to government bonds will be particularly attractive if interest rates remain at their current low levels, or if they rise at a very slow pace, as we expect.

Keeping pension portfolios on track

The strategic case for infrastructure stands. While returns are expected to be lower in absolute terms, they remain attractive relative to pension fund liabilities. The diversification and risk hedging characteristics of infrastructure assets remain intact, and infrastructure investments can in many cases help pension portfolios offset losses in the event of a market crisis, and continue to pay benefits.

However, expected yields and expected total returns on infrastructure investments should be adjusted downwards. Pension fund trustees who are considering investing in infrastructure may need to look to the higher-yielding end of the spectrum to compensate for lower returns from core infrastructure assets, being careful to differentiate opportunistic and value-added assets from core infrastructure. Those who are currently investing in infrastructure for the purpose of generating yield will need to consider whether any new investments can deliver their yield targets. It may be appropriate to combine their allocation to infrastructure with other asset classes and target protection from downside risk in order to attain target yields.

In any case, pension fund trustees should be explicit about the role they expect the infrastructure investments in their portfolio to play. If yield is their main objective, rather than diversification or downside risk protection, then they may need to adjust their expectations, and their portfolios, accordingly.