

Pension Fund Direct Investments in Infrastructure

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Among infrastructure¹ investors, pension funds are a relatively new player, having been active in the space for just over a decade. Pension fund interest in infrastructure investments has been driven by the desire to diversify portfolios away from cyclical investments in stocks and bonds into long-term, non-cyclical investments that match the long tenors of pension liabilities. The long investment horizons inherent in infrastructure assets are well-suited to pension funds. Infrastructure assets generate stable, inflation-linked revenues with a high degree of predictability, allowing pension funds access to a relatively low-volatility investment with moderate returns.

Traditionally, pension funds have invested indirectly in infrastructure through private equity-style infrastructure funds. However, the fees charged by these funds have sometimes eroded the modest returns associated with the infrastructure asset class and, as such, some of the more sophisticated pension funds have

opted to make direct investments, circumventing infrastructure funds altogether. The direct investment model has a number of advantages that benefit pension funds and serve to complement the traditional indirect investment model.

The following sections present a high-level overview of pension fund activity in infrastructure, beginning with a review of pension fund investment in infrastructure in general, followed by a review of direct investments by pension funds, and concluding with considerations on strategies for pension funds exploring direct investments in infrastructure.

RISING IMPORTANCE OF INFRASTRUCTURE

The exposure of pension funds to the infrastructure sector was much smaller in the past than it is today. The bull market of the 1990s presented a compelling case for large capital allocations in stocks. However, the early market decline in the following

decade exposed some of the failings of that strategy. Accordingly, pensions began to explore alternative asset classes with better risk profiles and lower correlation to the broader economy. Real estate portfolios were one option, as was infrastructure.

Infrastructure was particularly appealing to a number of pension funds (notably Canadian funds) due to the reasons previously mentioned, and many began reallocating capital to infrastructure. For example, the Ontario Teachers' Pension Plan began investing in infrastructure in 2001 and had over C\$7.1 billion, or 6% of its total assets, allocated to infrastructure in 2010.

The Dutch pension fund PGGM Vermogensbeheer (PGGM) has over €2 billion of committed and invested capital in infrastructure assets and hopes to increase that amount to €5 billion by 2015. According to Preqin,

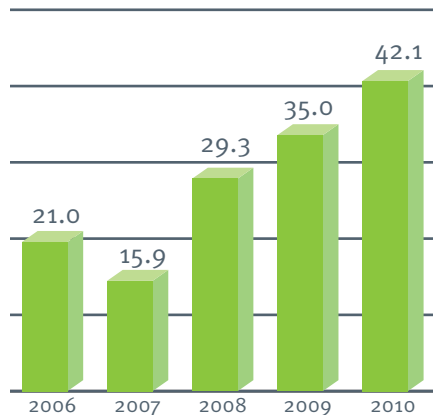
the mean current allocation to infrastructure by U.K.-based pension funds with infrastructure investments lies at 3.1%, with a mean target at 4.5%. Others, such as the Ontario Municipal Employees Retirement System (OMERS), have stated their intention to expand their infrastructure portfolio from 15.5% of their holdings in 2010 to 20% in the long term. In 2008, the largest U.S. public pension fund, the California Public Employees' Retirement System (CalPERS), with over US\$230 billion in assets, stated its intention to allocate 3% of its assets to infrastructure. Other U.S. pension funds, including the Washington State Investment Board, the Teachers Retirement System of Texas and the Kansas Public Employees Retirement System, have made similar commitments toward infrastructure investing. As infrastructure opportunities around the world continue to grow, this trend should continue.

Figure 1: Pension Funds With the Largest Infrastructure Investors by Value of Capital Created for the Asset Class in the Last Five Years

5	Ontario Municipal Employees Retirement System
6	Caisse De Dépôt Et Placement Du Québec
9	Ontario Teachers' Pension Plan
11	Canada Pension Plan Investment Board
15	ABP
22	Australian Super
25	Public Sector Pension Investment Board
28	Future Fund

Source: *Infrastructure Investor (2010)*

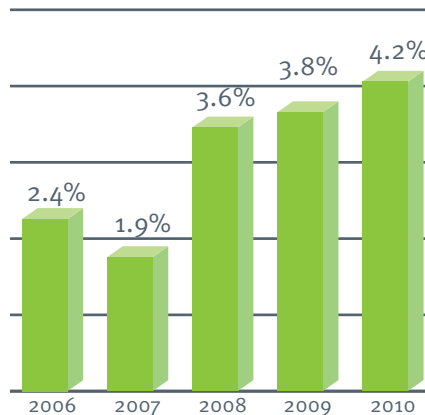
Figure 2: Canadian Pension Fund Infrastructure Investment (C\$ billions)²



The shift toward infrastructure investments by pension funds has not gone unnoticed by the infrastructure industry. Pension funds have become an increasingly important source of capital for infrastructure projects, as observed in a 2010 ranking from *Infrastructure Investor* of the 30 largest infrastructure investors. Of the 30 largest global investors in infrastructure, eight are pension funds. Out of those eight, five are based in Canada, two in Australia and one in the Netherlands, highlighting the leading position of Canadian pension funds in this trend (see Figure 1).

Out of the 10 largest infrastructure investors, three are Canadian pension funds; and out of the 15 largest

Figure 3: Infrastructure Allocation of Canadian Pension Fund Assets²



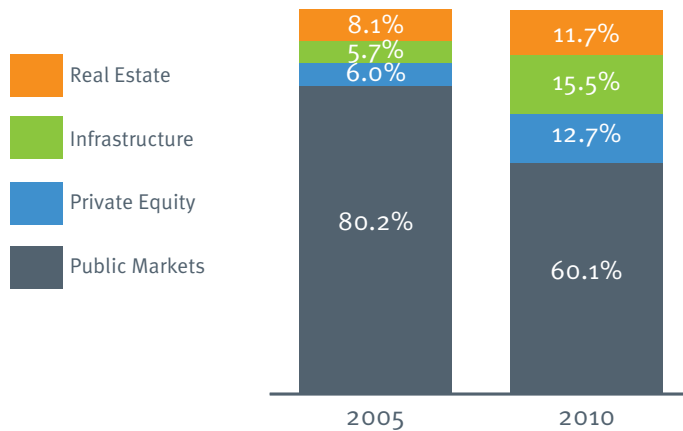
investors, there are no pension funds from other nations. All pension funds in the top 15 make use of direct investments in infrastructure.

SPECIAL NOTE: CANADIAN FUNDS

Canadian pension funds are some of the world's most sophisticated investors and have been especially active in infrastructure investing. These funds have doubled their infrastructure investments over the past five years, as seen in Figures 2 and 3.

OMERS provides one clear example of this growing trend, nearly tripling its infrastructure allocation from 2005 to 2010 (see Figure 4).

Figure 4: OMERS Asset Allocation



Source: OMERS

TREND TOWARD DIRECT INVESTING

Private equity-style funds focused on infrastructure have been the main avenue for pension funds to invest in infrastructure. This style of investment is well-suited for pension funds, which to some extent already rely on hedge funds and private equity funds to manage their capital. The higher risk inherent in the more speculative investments typical of hedge funds and private equity requires dedicated teams of experienced managers to properly evaluate each investment. Pension funds typically do not have such resources in-house. These higher risks, however, would theoretically result in higher returns, which could reach well into the double digits and adequately compensate for the management fees

charged by private equity and hedge fund managers. On the other hand, infrastructure investments, especially those directly in projects, have risk profiles that typically reflect thorough mitigation strategies that result in lower risk to both debt and equity investors. Accordingly, these investments also yield more modest (though not insignificant) returns. Pension funds that invest in infrastructure through specialized funds that charge management fees sometimes find their returns to be inadequate. Figures 5 and 6 reflect that understanding.

Mike Powell, Head of Alternative Investments at Universities Superannuation Scheme (USS), was quoted in the *Financial Times* as saying, “We used to invest exclusively in two infrastructure funds...but about a year ago, we began to review that strategy because we became dissatisfied by the funds’ performance and fee structures.” Likewise, PGGM is moving toward direct investments, as is AIMCo, which stated that a minority of externally managed assets account for a disproportionate amount of its expenses. In 2010, CalPERS invested directly in infrastructure for the first time, acquiring a 12.7%, or £106 million, stake in Gatwick Airport. OMERS has been investing directly for more than 10 years.

OMERS is the most experienced Canadian direct investor in infrastructure. In the late 1990s, the pension fund established Borealis Infrastructure (Borealis), a group with the sole mandate of investing in infrastructure. Borealis is a direct equity investor that exercises active management in every investment. It is managed separately from its parent institution, in part to avoid the bureaucracy that is often associated with pension funds. The group currently has interest in Enersource, Bruce Power, Enwave, Express Pipeline System, Oncor Electric Delivery Co., Scotia Gas Networks, Associated British Ports, High Speed 1 Limited, Ciel

Satellite Group, Lifelabs and Teranet. Borealis invested in the Confederation Bridge and the Detroit River Rail Tunnel projects. It also invests in Canadian “institutional facilities” such as hospitals, long-term health facilities and schools.

Likewise, AIMCo stated in its 2010 annual report that it is expanding its proportion of direct investments: “Direct investments will grow to approximately 75% this year, from 50% a year ago.” AIMCo has invested in Puget Sound Energy, Frequency Infrastructure Group, First Wind, Compañía Logística de Hidrocarburos and Thames Water.

Figure 5: Investor Views on the Key Issues Facing the Infrastructure Industry³

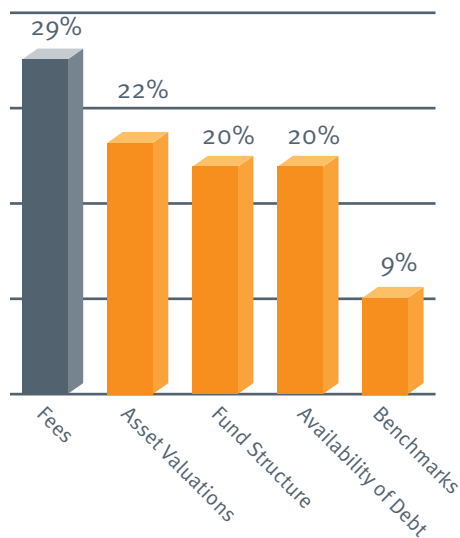
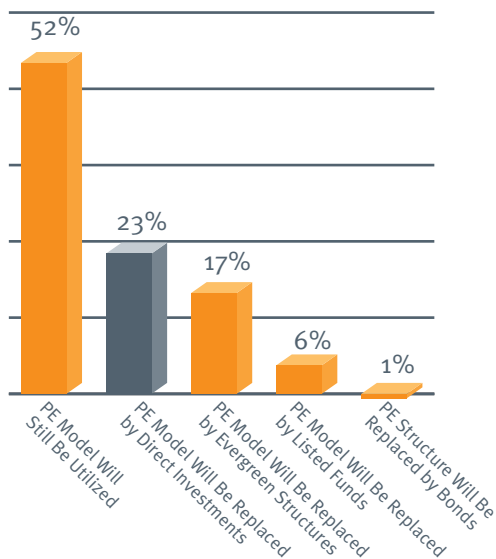


Figure 6: Investor Views on the Long-Term Viability of the Private Equity Fund Model for Infrastructure Investment³



CONCLUSION

The OECD estimates that the annual investment requirement for telecommunications, road, rail, water and energy infrastructure through 2030 is 2.5% of world GDP, or approximately US\$3 trillion per year. As governments increasingly look to the private sector to lead and finance infrastructure (especially in developed countries), pension funds may be presented with substantial attractive opportunities for investment in the near future.

In order to take advantage of these infrastructure investment opportunities, pension funds may take the traditional route of indirect investing through specialized, private equity-style funds or may invest directly, as a number of larger pension funds have opted to do. Direct investment in infrastructure is not always straightforward, often requiring specialized teams and skills to evaluate transactions and deploy capital appropriately. Specialized funds fulfill these requirements for pension

funds, but charge substantial fees for their expertise (which is not to say that these fees are unwarranted, as in many cases they are well-earned). Larger, more sophisticated pension funds may develop—and some already have—their own internal teams with experience and skills comparable to those of private equity-style funds in order to take the direct investment route. Mid- and small-size funds may also invest directly with the assistance of financial advisers working on a transactional basis, reducing the need for long-term expenses associated with an internal team as well as the management fees associated with infrastructure funds.

The expansion of the infrastructure asset class to a wider base of pension funds can greatly benefit all parties involved, facilitating much-needed capital to aid infrastructure development and providing attractive, non-cyclical investments to investors in need of fixed income-style cash flow profiles with higher returns.

¹ We broadly define infrastructure by its financial characteristics: stable, inflation-linked cash flows over longtime horizons, and low correlation to business cycle and debt and equity markets. We categorize toll roads, LNG terminals and airports as infrastructure assets, along with schools, prisons and other social infrastructure facilities.

² Source: *Public Investment Association of Canada*

³ Source: *Preqin*