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Infrastructure Goes Global

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Introduction

Infrastructure is now increasingly accepted as a separate asset class that plays a distinctive role in a multi-asset portfolio. Institutional investors, searching for higher-yielding and stable investments, have flocked to this space globally. For pension funds in particular, the long duration, steady cash flow and inherent inflation hedge of mature infrastructure investments hold considerable appeal.¹ There are numerous vehicles for accessing infrastructure, most of which are presented below. As the asset class becomes well-established in institutional portfolios, an increasing number of mandates are going global. The purpose of this report is to provide a framework for a global allocation to infrastructure investments. After providing three market neutral allocations based on various size measures, three varied global portfolios are presented. Each portfolio provides a different risk-return profile and the optimal global allocation decision will depend on the return and risk preferences of individual investors.

Investment Vehicles and Strategies

The growing demand for infrastructure investments is being met by an array of investment options. Institutional investors can acquire exposure to infrastructure in a variety of ways, including listed funds, unlisted funds, dedicated secondary funds, co-investments or direct investments. The main vehicles for accessing the infrastructure universe include:

- **Listed infrastructure funds:** These funds invest in infrastructure securities listed on global stock exchanges. There are currently many global infrastructure funds in development. Some funds invest in infrastructure-related operating companies, while others are securitized portfolios of individual infrastructure assets.
- **Unlisted infrastructure funds:** These are very similar to unlisted private equity real estate funds. They invest in a range of infrastructure assets and development projects worldwide.
- **Infrastructure debt funds:** Within a structure similar to unlisted infrastructure equity funds, these funds target investments in infrastructure debt. They typically have enhanced yield targets and are similar to many private debt funds focused on other sectors.
- **Co-investments/direct investments:** Larger institutional investors, especially in Canada and Australia, have been investing directly in large-scale infrastructure projects globally. Due to these investors' larger size, they can still achieve a degree of diversification within their infrastructure allocation despite each asset's high capital requirements.

Each of these investment options also provides a broad spectrum of risk and return profiles. Institutional investors that have a high requirement for income are well suited for a core strategy that focuses on late-stage, mature investments. Such investments provide more predictable income streams with less volatility. A value-add strategy may focus on growth through re-development or expansion of an existing strategy. Such a strategy may offer less predictable income initially, but more capital appreciation at exit. Opportunistic infrastructure

¹ For a more comprehensive review of the unique features of infrastructure, please refer to "Performance Characteristics of Infrastructure Investments," RREEF Research, August 2007.

Prepared By:

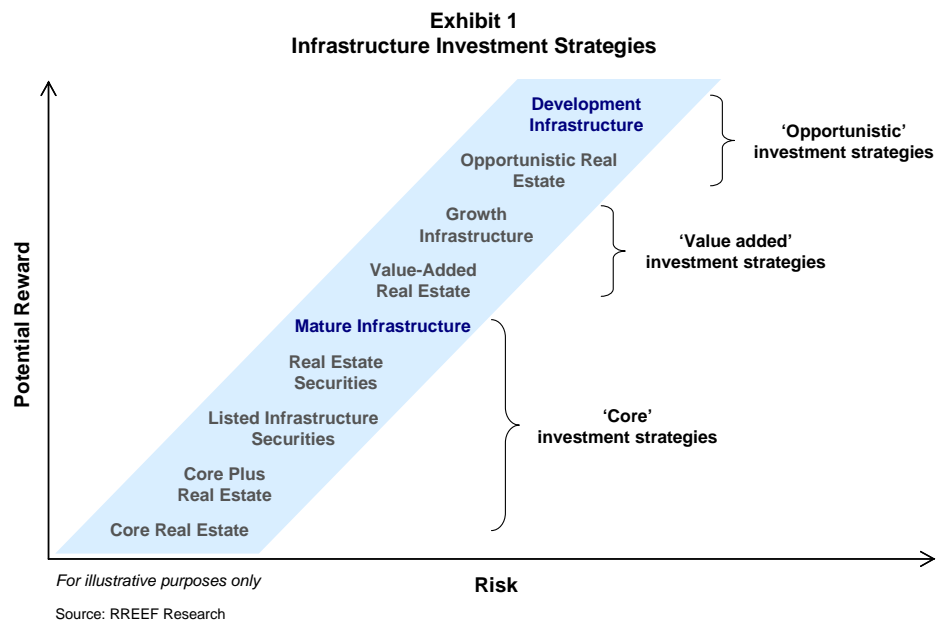
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strategies typically take on more development and greenfield risk, with minimal income growth during the hold period and with much of the gain realized through capital appreciation at exit. Exhibit 1 illustrates the range of investment strategies available to investors and their associated risk/return profile.

The Globalization of Infrastructure Investments

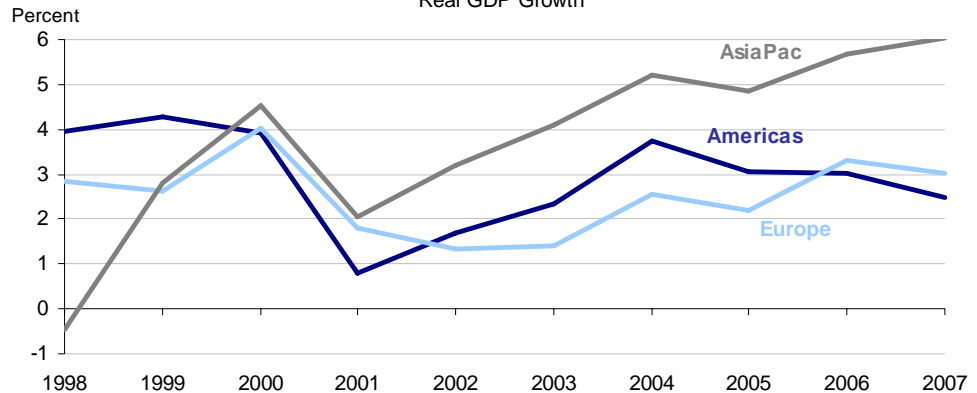
In addition to the availability of a variety of vehicles and strategies, global exposure is now available for overall infrastructure allocations. Much of the initial infrastructure investments have had a large domestic focus. The domestic-orientation of investments has been true for the broad spectrum of alternative investments including real estate, private equity and infrastructure. Returns have been high domestically and a high degree of uncertainty and risk has been associated with the emerging economies, especially Asia. Up till now, there has also been difficulty in executing a global strategy given the scarcity of viable global infrastructure investment vehicles.



Given the heated interest in infrastructure investments, global investment vehicles are now emerging as well. Over the past ten years, increased trade, less regulation, and increased transparency has led to the evolution and maturation of global markets. There is a case to be made for the enhanced diversification benefits of a global infrastructure portfolio, very similar to the case for a global real estate portfolio.

Infrastructure provides an essential service whose demand and supply fundamentals are highly local. As a result, infrastructure markets are less correlated around the globe and this should improve the diversification of a global infrastructure allocation. As reflected in Exhibit 2, different regions are operating at different phases of their business cycle. Fast-growing Asian markets exhibit much stronger economic and population growth, whereas the Western, developed regions exhibit less volatile economic growth patterns. Taking advantage of regional differences in a global infrastructure allocation can enhance portfolio returns while reducing volatility.

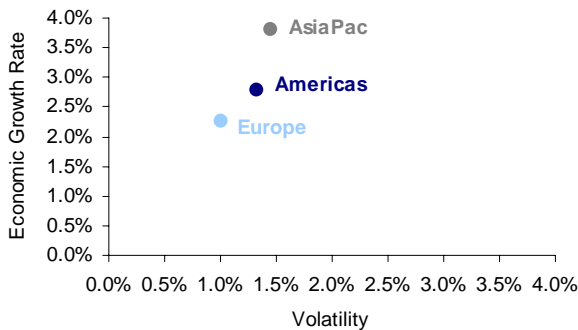
Exhibit 2
Regional Business Cycles Are Not Synchronized
Real GDP Growth



Source: Global Insight

Exhibits 3a and 3b depict growth, economic volatility, and correlations for 3 major global regions including the Americas, Europe, and Asia/Pacific (AsiaPac). The path of economic performance is highly varied across the three major regions. For example, the AsiaPac region underwent a major recession during 1997-1998, whereas the impact on the rest of the world was relatively less. Since 2001, however, economic growth in the broad and diverse AsiaPac region has outpaced the Americas and Europe. Clearly, each region is exhibiting divergent growth patterns.

Exhibit 3a
Strong Growth Comes with More Risk
Real GDP Growth
1997-2007



Source: Global Insight

Exhibit 3b
Low Regional Correlations
1997-2007

	Americas	Europe	AsiaPac
Americas	1		
Europe	0.64	1	
AsiaPac	(0.02)	0.24	1

Stronger growth, however, comes with a greater degree of risk. In Exhibit 3a, we measure risk as the volatility or standard deviation of each region's growth rates. Also, each region's economic growth rate is a good proxy of the overall returns that can be generated in each case. Europe has the slowest growth rate but also one that is more stable relative to the Americas and AsiaPac. The Americas is in between that of Europe and AsiaPac in terms of its economic risk/return profile. By contrast, the AsiaPac region provides the greatest amount of potential return relative to the other two regions.

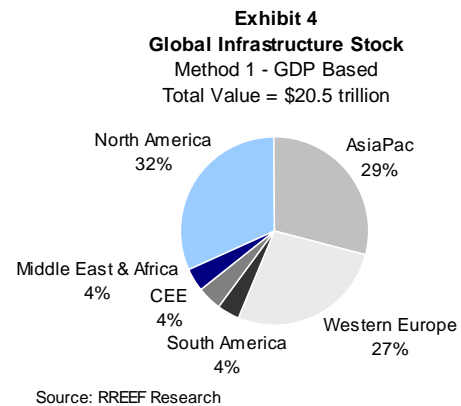
The divergent growth paths of the world's three major regions are also depicted by correlation measures. Exhibit 3b depicts correlations between the economic growth rates of the three regions for the period 1997 through 2007. All correlations are less than one, indicating lack of perfect correlation among regions. The Americas and Europe show a higher correlation; AsiaPac shows the lowest correlation with either region. The lack of perfect correlation provides the rationale for greater diversification benefits of a global infrastructure portfolio.

Portfolio managers can optimize returns for a given level of risk by tactically allocating across the three regions. Since infrastructure investments are long term investments, an active portfolio manager can alter regional allocations based on long-term expectations.

There is, thus, a strong case for a global allocation to infrastructure. Therefore, in the next section, we look at different ways of gauging optimal allocations across the various geographies by looking at the size of the infrastructure universe, the volume of transactions activity globally, and by the regional allocations that are implied in the listed infrastructure securities universe.

Market Neutral Allocations

Investors should be making strategic allocations to global infrastructure within their multi-asset portfolio. But what determines the regional allocation metrics? Is there a systematic way of gauging optimal regional allocations across a privately-held global infrastructure portfolio? Regional allocation decisions for public market investments are often based on the size and distribution of the global investible market across regions and historic risk/return performance by region.



Unlike public markets, however, private, unlisted infrastructure does not have a readily available time series on returns, size, market capitalization, or other variables used to determine optimal allocations. In this section, we provide three ways of deriving “market neutral” allocations, including (1) the size of the global infrastructure universe, (2) the size of the global listed infrastructure universe, and (3) the volume of global infrastructure transactions over the past three years.

1. The Size of the Global Infrastructure Market

RREEF Research has recently set out to estimate the size of the global infrastructure market since this data is not readily available.² This includes all infrastructure assets, whether privately-owned or publicly-owned. It also includes all infrastructure assets whether traded on the public markets as listed securities or those assets held in private unlisted funds. It, thus, has the widest coverage among three market neutral allocations presented in this section.

There are various methodologies for estimating the size of the global infrastructure universe. We use a GDP-estimate approach. The US is used as a base, since it is the only country for which infrastructure size estimates exist. The methodology used to size the market is presented in detail in the Appendix following this report. Briefly, if we assume that the value of a nation’s infrastructure stock is as highly correlated with GDP as stock market cap, then it makes sense to use GDP-based estimates as a starting point. Assuming the same infrastructure-stock-to-GDP ratio that holds in the US applies elsewhere, we can estimate the size of the global infrastructure market using national GDP numbers. That is the methodology used to come up with an estimate valued at \$20.5 trillion.

There is also a strong correlation between a country’s development, and the quality and amount of its infrastructure assets. Using this method, the more advanced the country as measured by size of GDP and GDP per capita, the greater the size of their infrastructure

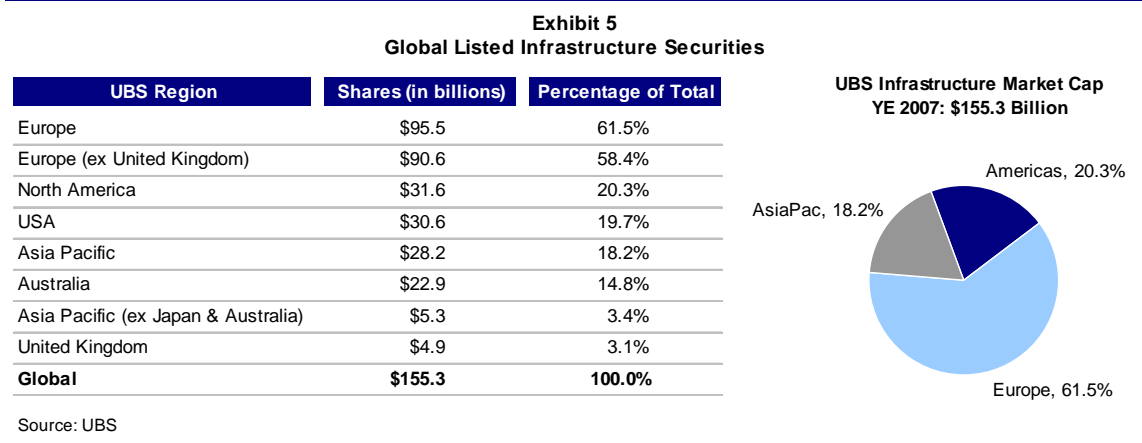
² Please refer to the RREEF publication, ‘Estimating the Size of the Global Infrastructure Market,’ September, 2008.

assets. The regional shares are presented in Exhibit 4. This size estimate provides the value of the total infrastructure stock in each region and not purely the investible universe. Data on the investible infrastructure universe is non-existent. The size measure does provide, however, the potential infrastructure investment opportunity in each region. It also suggests an allocation framework that provides investors with broad diversified exposure to various geographic locations and infrastructure sectors.

The size of the global infrastructure universe and the regional shares can provide one proxy for a market neutral allocation. According to this method, if investors want a pure market weight allocation, they should allocate 36% to the Americas, 31% to Europe, 29% to AsiaPac, and 4% to the Middle East and North Africa (MENA).

2. The Size of the Global Listed Infrastructure Market

Another method in determining market neutral weights is to look at the global listed infrastructure market. UBS has recently launched a listed infrastructure benchmark covering all regions of the world. The benchmark includes all listed infrastructure securities on the public market. The market capitalization as of year-end 2007 was \$155.3 billion, so it provides a much narrower focus. It also is dominated by mature markets that have a well-developed listed securities market. The regional shares of the UBS global listed infrastructure benchmark are presented in Exhibit 5.



The global listed infrastructure markets are dominated by Europe (61.5%), mostly the UK and the Eurozone. Infrastructure investments have a long track record in Europe starting with ex-Prime Minister Thatcher's privatization efforts over two decades ago. It is not surprising that Europe accounts for the lion's share of the listed infrastructure market globally since for many investors, a viable exit strategy over the past two decades has been an IPO in the public markets. The securitization of infrastructure investments has had a longer track record in Europe and Australia relative to other parts of the world.

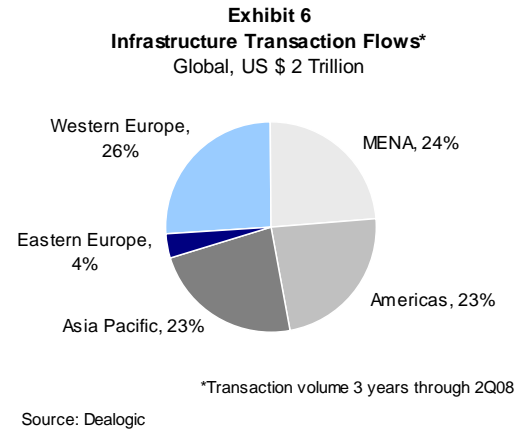
Europe is followed by the Americas (20.3%) which only consists of the US and Canada. This is followed by the AsiaPac region which accounts for 18.2% of the global listed infrastructure universe, but the majority of that is attributed to Australia alone. Indeed, Australia accounts for 14.8% of the global listed infrastructure market. The large share of Australia in the listed public markets is also not surprising since infrastructure has been widely recognized as a separate asset class for more than a decade. Australian investors have been committing to both private and public infrastructure investments for many years.

The UBS benchmark highlights the regions that have more mature infrastructure markets. There is a close correlation between mature asset classes and the degree to which they are traded in public markets. As such, a global allocation that uses the UBS index to determine a market neutral allocation is highly skewed to the developed and/or mature infrastructure markets, with stable returns and a greater degree of transparency.

3. The Volume of Transactions

Instead of calculating the stock of infrastructure assets or the market cap of listed infrastructure globally, an alternative method to determine market neutral weights is to look at the flow of infrastructure transactions around the world. This provides a perspective regarding regions of the world that are investing in their infrastructure since much of the transaction flow data is focused on new development. Dealogic provides a comprehensive database on infrastructure transaction volume across individual countries. Exhibit 6 below provides infrastructure transaction volume for the past three years through the second quarter of 2008. Transaction volume for that period totals \$2 trillion which far surpasses the market capitalization of infrastructure securities.

The regional distribution of infrastructure transaction flows is more equitable across regions. The Americas accounts for 23% and MENA for 24%. There are many oil/energy and gas distribution network projects being launched in the broad MENA region. On a global basis, oil/energy, petrochemicals, and power account for 56% of all infrastructure transactions over the past 3 years.



The MENA region is followed by AsiaPac with a 23% share. Western Europe, which is a relatively mature infrastructure market, accounts for 26% of infrastructure transactions. Emerging Eastern Europe accounts for 4%. There is both private and public financial capital targeting the development of enhanced infrastructure assets in Eastern Europe.

The transaction flow market weights are slightly skewed to the emerging markets that are fast developing their infrastructure. Again, for these high-growth markets, there is an acute need for infrastructure and therefore most of the infrastructure investment opportunities in these regions target greenfield and opportunistic strategies. The transaction flow data provides an assessment of the type and volume of infrastructure development deals that are occurring worldwide. Investors that develop the market neutral weights based on the regional shares of transaction volumes are skewing their portfolio to higher risk markets and higher risk infrastructure strategies.

Three Representative Portfolios

A geographically well-diversified infrastructure portfolio benefits investors, but how should investors construct such a portfolio? The three market-weight allocation benchmarks provide a starting point. Each has a slightly different bent and risk level as illustrated in Exhibit 7.

**Exhibit 7
Market Neutral Regional Allocations**

Method	Americas	Europe	AsiaPac	MENA	Risk/Comments
Universe of Global Infrastructure	36%	31%	29%	4%	Medium - Skewed to large economies
Listed Market	20.3%	61.5%	18.2%	0%	Low - Skewed to mature infrastructure economies
Transactions Market	23%	30%	23%	24%	High - Skewed to emerging infrastructure economies

Source: RREEF Research

Depending on the level of risk tolerance, investors can have an overweight (relative to the three benchmarks) to those regions that have the highest returns and still relatively favorable risk/return characteristics. Below we provide three different representative portfolios, each with a different risk return profile. Portfolio A has a greater concentration in developed markets that have benefited from the privatization of their infrastructure assets. These markets provide a greater number of existing and mature infrastructure assets with a proven history of steady cash flows. Investors that have a greater need for income would find portfolio A to provide the preferred regional allocations.

**Exhibit 8
Three Representative Globally-Diversified Infrastructure Portfolios**

	Type	Risk	Investment Focus	Refined Allocations
Portfolio A	Income-oriented	Low	Mature, Later-stage, Core	<p>Americas, 30% Europe, 50% AsiaPac, 20%</p>
Portfolio B	Value-oriented	Medium	Mature, Value-add Investments Some Development	<p>Americas, 40% Europe, 40% AsiaPac, 20%</p>
Portfolio C	Growth-oriented	High	Early-stage, Development Opportunistic	<p>Americas, 30% Europe, 30% AsiaPac, 40%</p>

Source: RREEF Research

By contrast, portfolio C is heavily skewed to emerging countries where much of the infrastructure investments are greenfield development. Investors that have a greater tolerance for risk and a longer time horizon for harvesting returns should benefit more from portfolio C.

Concluding Remarks

As institutional investors build ever more global portfolios, among the last asset classes to remain predominantly local is infrastructure. Most institutional investors dramatically overweight their home country and continent in their allocations to infrastructure.

Given the low correlation among regions and the local nature of infrastructure assets, a globally diverse portfolio can enhance returns. Infrastructure investors should make a strategic allocation to global infrastructure, where the regional allocations are a function of the relative risk tolerance.

In this report, we provided both market neutral allocations and representative sample portfolios that can match the risk/return profile of individual investors. Either choice depends on the risk/return profile and actuarial requirements of institutional investors.

Appendix: GDP Methodology

GDP Adjusted for Quality Method for Estimating the Size of the Global Infrastructure Market

Background

In an effort to understand the scope of the global infrastructure market, an alternate course is to use measures of GDP as a proxy for relative size of the universe. Based on available evidence, there is a high correlation between the size of a nation's asset stocks, like equity market capitalization and real estate, to their respective level of GDP. This correlation is robust across developed and emerging markets worldwide. It is therefore reasonable to assume that the collective value of a nation's infrastructure assets should be proportional to their economic output.

Additionally, the quality of infrastructure across nations varies significantly which will impact the relative value of the asset. This should also be taken into account when measuring the approximate size of nation's infrastructure market. Take for example two nations with similar levels of GDP, such as Germany and China. At first pass, it would be expected that two economies of the same size should have comparable provisions of infrastructure. Yet, the average level of infrastructure quality in China is perceptibly lower than the average level of quality in Germany, therefore China's infrastructure market size is presumed to be smaller than that of Germany.

Taking into consideration a nation's GDP and overall quality of infrastructure, we are able to arrive at an alternate method for estimating the size of the infrastructure market.

Data

Data was obtained from the US Bureau of Economic Analysis (BEA) Fixed Assets Accounts for estimates of the size of the US infrastructure market. In 2006, the value of the stock of US economic infrastructure – including utilities and transport, but not including social infrastructure like schools and hospitals – amounted to just over \$6 trillion. This represented 45.9% of US nominal GDP in that year. Using the ratio of total value of US infrastructure to total value of US GDP, inferences were made about the size of the global infrastructure market.

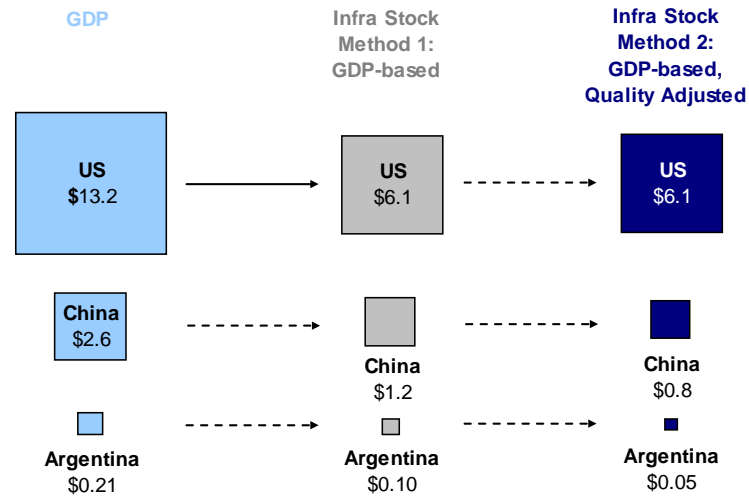
Several data sources exist to document the quality and quantity of infrastructure. Available data includes World Economic Forum rankings of infrastructure quality based on executive surveys, as well as World Bank estimates of per capita access to infrastructure. Given the robustness of infrastructure quality metrics by the World Economic Forum (WEF), their rankings were used to adjust our estimates of the size of infrastructure asset stock by country. The WEF numbers take the form of an index ranking that allows us to compute each nation's quality gap (or premium) versus the United States. This quality gap/premium is then used to adjust the GDP-based estimates based on the BEA data.

Methodology

The methodology for this estimation approach essentially consists of two parts. First, a benchmark for infrastructure size is determined and the ratio to GDP is applied globally. Next, our GDP-based estimates of infrastructure size are adjusted for each country based upon the quality of their stock.

Three countries are used to illustrate how the two stage estimation process works: the US, China and Argentina. (Please see Exhibit 9.)

Exhibit 9
Estimating Total Infrastructure Stock
 All values in Trillions of USD



Source: RREEF Research, Global Insight and US Bureau of Economic Analysis

Stage 1 takes each country's 2006 GDP as a starting point for calculation. The US infrastructure stock as a percent of GDP – 45.9%-- is multiplied by national GDP to get an estimate of national infrastructure stock in dollar values. For example, China's GDP was \$2.6 trillion in 2006, so infrastructure market size is estimated at \$2.6 trillion x 45.9% = \$1.2 trillion. Aggregating our individual country results globally, this method yields an estimated market size of \$21.5 trillion, as of 2006.

Stage 2 builds upon the GDP-based values generated by Stage 1. From here, quality gap vis-à-vis the US is used to adjust the Stage 1 value. The data source used here is World Economic Forum quality gap/premium estimates. These index rankings are from the WEF Global Competitiveness Report 2007-2008. For example, Argentina's estimated infrastructure stock from Stage 1 is about \$100 billion. The quality of Argentina infrastructure is roughly 50% of that in the US. Therefore, the quality-adjusted estimate of Argentina market size is approximately \$50 billion. Note, Stage 2 and Stage 1 values for the United States are the same, since all quality adjustments are measured against the quantity and quality of US infrastructure. When the GDP-based values of Stage 1 are adjusted for quality, the value of the global infrastructure market becomes \$18.9 trillion.

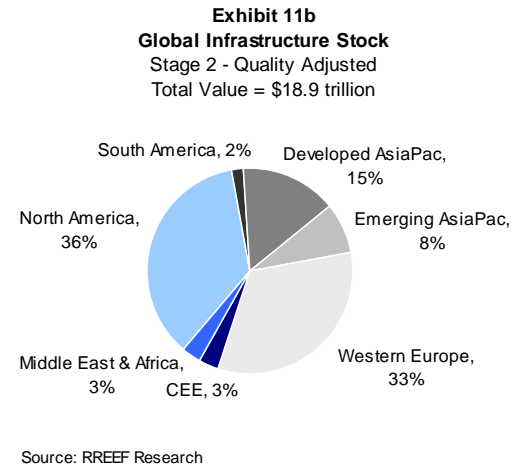
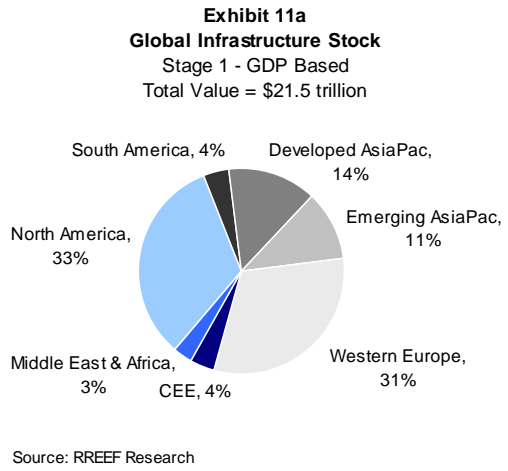
Results

The current estimated market size of global infrastructure, based upon our current estimation technique, comes to \$18.9 trillion. Of this, 83% of the market value is concentrated in developed nations while the remaining 17% is in emerging nations. Regionally, the distribution of infrastructure assets is 23% Asia, 33% Western Europe, 36% North America, 2% South America, 3% Eastern Europe and 3% Middle East and Africa. The nations with the largest levels of infrastructure are depicted in Exhibit 10.

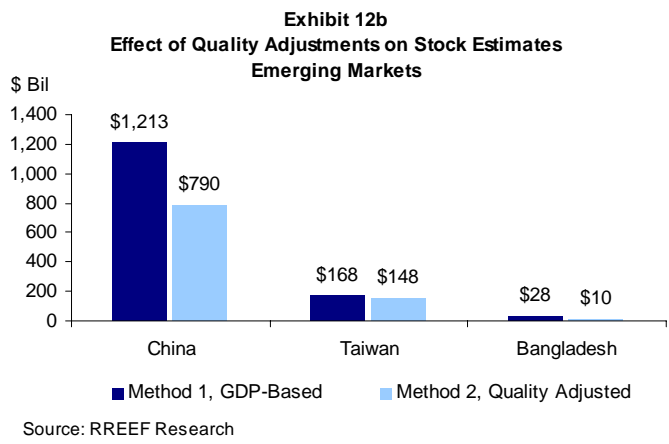
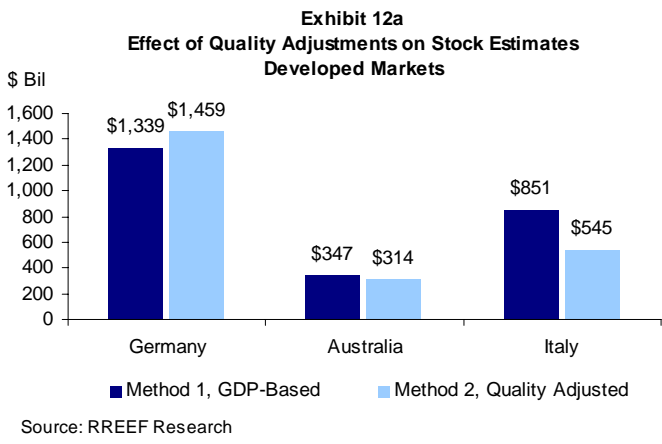
Exhibit 10
Nations with Largest Levels of Infrastructure
 (in USD trillions)

United States	\$6.1
Japan	\$2.0
Germany	\$1.5
France	\$1.1
United Kingdom	\$1.0
China	\$0.8
Canada	\$0.6
Italy	\$0.5
Spain	\$0.5

Source: RREEF Research



We found that quality adjustments lowered the emerging markets' share of global infrastructure because many developing countries have poor to moderate infrastructure quality rankings. The chart below summarizes how quality adjustment affects market size estimates. For a handful of countries, including Germany and Hong Kong, quality adjustments increased the value of estimated infrastructure stock. In general, though, most countries saw a downward revision in market size as a result of quality adjusting.



Caveats

As with the net capital stock approach to estimating the size of the infrastructure universe, there are a number of limitations to the GDP, quality-based approach as well. First, it is implicitly assumed that the ratio of infrastructure asset stock to GDP that holds in the US applies elsewhere. This is clearly an awkward assumption when we are estimating across countries with varying levels of economic development, population, land area and so forth.

Second, our adjustments for quality are based on a ranked index that measures the gap in infrastructure between countries that are not easily quantifiable in monetary aggregates. In the WEF rankings, the country with the best infrastructure is Germany, with infrastructure approximately 10% better than the US. The country with the lowest-quality infrastructure according to the WEF is Bangladesh. The quality level of infrastructure in Bangladesh is estimated at just 35% of the US level. A basic assumption was made that a 10% premium in infrastructure means that it is worth 10% more in value. Similarly, a 35% deficit in infrastructure means that it is worth 35% less in value. The one-to-one relationship between quality and value is based on conjecture, not empirical evidence.

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