First State Investments

*Recently, **Sheila Hopkins,** managing director – Europe and infrastructure with Institutional Real Estate, Inc., spoke with **Danny Latham** of First State Investments. The following is an excerpt of that conversation.*

Danny Latham is a partner with First State Investments' infrastructure business. He has more than 19 years of direct infrastructure investment experience as a fiduciary, including three years in London and Sydney at RREEF Infrastructure, a Deutsche Bank subsidiary, and was a founding member of the AMP Group's infrastructure team in 1994.

How has infrastructure evolved as an asset class?

The infrastructure sector has evolved into its own asset class in the almost 20-year period that I have been buying and managing infrastructure assets on behalf of pension funds. It is not private equity and it is not property, although it has characteristics of both across the spectrum. However, infrastructure has many more stakeholders than, say, an individual property or an individual business in private equity hands. Infrastructure is fundamental to the efficient operations of society, and therefore, everyone who uses infrastructure, which is everyone in the community, also feels like an expert on the topic.

Are infrastructure investment needs different around the world?

The developed world is moving into a replacement and refurbishment stage, whereas the developing world is in a new-build situation. Either way, the investment need is enormous, with the McKinsey Global Institute forecasting $57 trillion of infrastructure investment being required between now and 2030 to keep pace with GDP growth. The traditional providers of that capital, predominantly governments, are increasingly finding their own finances stretched. They are becoming current expenditure focused rather than capital expenditure focused, so the ability to undertake such an enormous investment is diminished. Fortunately, capital is mobilizing from other sources — pension funds, insurance companies and sovereign wealth funds — though I suspect that will be insufficient for the investment required long term.

A lot of capital is being raised for the infrastructure sector, but is it being raised for what is really being needed?

Much of the investment need is of a greenfield nature, and what investors are actually wanting, particularly in the current macroeconomic environment where interest rates are at historic lows, is high-yielding assets and by definition yielding assets only occur once they are operational. The answer is not the same in all cases, but it comes down to: Who should be the natural developer and/or builder of new infrastructure? I would argue that some sort of partnership between government and industry with assets recycled to long-term owners, like pension funds, when the operating track record is proven. Therefore, the principle is that those who are best placed to price and/or manage risk should take it.

Is the comfortableness to take this development risk different in different regions?

It is not so much region specific but more related to the maturity of the infrastructure investment program. I think it also depends on what investors want out of infrastructure. If you want it to be a fixed-interest substitute, then you want it to yield straight away, hence a bias toward operating assets that have minimal or predictable construction risk or development risk. If the portfolio is a little bit more mature and you have a good foundation, then we are increasingly seeing investors then decide to expand their core portfolio into some satellite strategies, for instance, going into emerging markets or alternatively going out along the risk curve within their own market, which could involve going up the greenfield curve.

Is infrastructure investing only for the bigger pension funds? Is it even appropriate or necessary for the smaller funds?

The investment characteristics and the investment outcomes shouldn't be terribly different from the perspective of a large fund or a small fund. Both are looking to the asset class to solve the same thing, which, in our experience, is stability of returns at a level that meets their pension obligations in five, 10, 15, 20, 30 years' time. There are obviously multiple paths to access exposure to this sector. One is a niche listed equities strategy, targeting infrastructure securities. This strategy will give you some exposure to the characteristics of the sector through listed companies, but with the listed markets, you get increased volatility but also greater liquidity. If you go into the unlisted space, there are a number of paths — funds of funds versus individual funds versus direct investing. The path taken will depend on the size of the allocation, investment strategy and the size and capability of the in-house team. More than most other asset classes, a number of investors want to go direct, rather than via funds or syndications or so forth. We find that quite odd really. These assets don't look after themselves; they are living, breathing businesses that need to be managed and, in many cases, even more so than a private equity businesses or a specific property. We have seen some pendulum shifts amongst some of the big investors, where they started with a fund strategy then became direct investors and have now come back into the middle with a hybrid fund/co-investment strategy. Some have realized that it is very difficult to do everything on your own from originating, evaluating, executing and managing investments. Whilst I am clearly biased, if I were implementing an infrastructure investment program, I would seek to "rent" expertise from industry practitioners who have the skills and experience in the preferred sectors and geographies.

How does First State actually attack the market? Are you focused on funds or club deals?

We have been doing this for almost 20 years, and our business is a combination of commingled funds and dedicated separate accounts with a focus on the transportation and utilities sectors. We generally target lead or co-lead positions and are comfortable taking 100 percent of an asset. Consortium deals are also welcome where partnering provides risk mitigation and/or value creation options. An example of this is where we have partnered with Schiphol from Amsterdam Airport in investing in Brisbane Airport since 1997. We are a value investor in search of investments that deliver attractive risk-adjusted returns to our clients. Currently we see better value in the mid-market and are shying away from hunting elephants or trophy assets to be displayed on the mantle piece. We are not buying assets for the wrong reasons. At the moment, the bigger the asset, the more money is chasing it. We see good deal flow in Europe, where corporates are divesting noncore assets, with the same theme evident in Australia as well, as a second wave of privatizations following the first wave of utility and transportation sales back in the 1990s. We expect increasing deal flow to emerge in North America with a bias toward the energy sector.

How has the global financial crisis affected the industry?

The GFC has impacted the industry in terms of the supply and financing of investments as well as fund terms. As we enter a lower growth and return environment post-GFC, there has been an increased focus on risk and costs, with a shift away from traditional private equity–style models and a desire to go direct. One of the factors that has pushed investors toward wanting to go direct rather than into funds is this issue of trust: Can they trust what managers are doing? Are they going to deliver on the investment strategy? Will the team stay? Is there enough transparency around governance? Are they too expensive? There has also been a GFC impact on the investment landscape. In broad terms the financing structures have become more rational and investment opportunities are increasing as current owners, whether they be governments or strategics, divest noncore assets to pay down debt or devote expenditure to their core business.

What differentiates First State from other managers in this space?

Our view is that infrastructure investing is for the long term, and therefore assets need to be managed on a sustainable basis with due regard to all stakeholders. As stewards of our clients' money, our primary obligation is to understand and satisfy our clients' objectives. This is a responsibility we take very seriously. We see our clients as our business partners, and we work with them on that basis. We are an active manager; we don't see infrastructure as a passive strategy. We have the skill sets in our team to source assets, evaluate them and, most importantly, manage them. You will never please everyone all the time. But if we put customers at the forefront of everything we do, then that will go a long way to addressing some of the concerns directed at the sector.

Is it a problem that the infrastructure asset class doesn't have a benchmark in the way that the NCREIF Property Index is a benchmark for the real estate market?

It is a problem, but only time and depth of market will sort it out. It is not something that is going to happen overnight. It's important to remember that NCRIEF in the early days took a good while to catch on, and it needed the depth of the market to develop and the number of contributing funds to increase to provide the diversity and depth of the underlying benchmark. In Australia, Mercer and now IPD have been compiling an index based on about six or seven different funds over the past 10 years, so you will start to see some longevity in the benchmark come out of this market as they develop. In our case, we tend to have more of an absolute return or CPI-linked benchmark that matches our clients' targeted return strategy.

What does the future hold for infrastructure investing?

We are very bullish on the sector in terms of the raw investment need required. It is certainly a long game, not a short game, and whilst there may be short-term aberrations, the long-term fundamentals are strong. Some market distortions can result from political influences where there is a mismatch between infrastructure investment decisions being for 20-plus years, but an electoral cycle is three to five years. An effective way to mitigate this risk is to have your customer front and center of everything you do. You need to deliver value. We are all required to do more with less, and you must be delivering a value proposition. ❖