Finding value: the North American infrastructure opportunity

GREGORY SMITH OF INSTARAGF OUTLINES HOW INCREASING URBANISATION AND FACTORS SUCH AS THE DRIVE FOR GREEN ENERGY PRODUCTION AND DISTRIBUTION ARE CREATING OPPORTUNITIES FOR INVESTORS

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The world needs infrastructure: more than US$57 trillion is required globally between now and 2030 to modernise and build essential infrastructure across various sectors, according to the McKinsey Global Institute.

The emergence of infrastructure as an asset class over the past 15 years is largely attributable to this staggering need for capital – and the incapacity of governments to foot the mounting bill. At the same time, investors are seeking real alternatives that are resilient to economic cycles, have lower correlations with traditional asset classes, provide inflation protection, and deliver current yield. While the infrastructure asset class is relatively young, it has generally delivered stable returns with a critical mass of evidence suggesting that adding infrastructure to a portfolio typically brings diversification benefits, improves return per unit of risk, and enhances overall efficiency. According to Preqin, the average institutional allocation to infrastructure increased to 4.3% in 2015 from 3.5% in 2011, and more than two thirds of investors plan to further increase their infrastructure allocation over the long term.

Infrastructure investment catalysts

As the infrastructure asset class becomes more established and as capital increasingly flows into the sector, investors should look beyond auctions and the more traditional core infrastructure "mega" transactions making headlines – where the market is extremely competitive – to those sectors and geographies that are experiencing fundamental or sustained change, which gives rise to higher value investments. Our investment strategy at InstarAGF, for example, focuses on middle-market core value-added infrastructure in North America. This jurisdiction features a relatively stable legal, regulatory and financing environment to underpin investment returns yet offers scope for innovation in developing and structuring investment opportunities.

This need for innovation emanates primarily from the rapid, intense urbanisation of North America, where 80% of the population now lives in urban centres. The McKinsey Global Institute notes that about 20% of global GDP comes from 190 North American cities alone, which makes investing in urban infrastructure a vital strategic and economic imperative for governments in Canada and the United States. Multiple investment opportunities are arising in response to the immensely complex demographic, technological and environmental challenges posed by urbanisation. These opportunities are coming to market by way of traditional public-private partnerships or government asset sales, and also through newer contractual or alternative financing frameworks ranging from concession-like structures to green bonds.

I believe that municipalities, along with universities, schools and hospitals, known as the "MUSH" sector, are likely to be the predominant catalyst for expanding private sector involvement in infrastructure delivery in North America. Fifty years ago, these local governments accounted for about 35% of all infrastructure spending. Today, they are responsible for 70% to 80% of public infrastructure assets, yet typically collect just 10% of every tax dollar – creating an enormous funding gap.

Middle-market value proposition

InstarAGF's emphasis on the middle market, which we define as assets with an enterprise value of CDN$100 million to CDN$1 billion, aligns well with these evolving and underserved community infrastructure needs. Further, such middle-market

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investment opportunities typically are sourced through relationships as opposed to auctions, which allows for flexibility around the timing and structuring of a deal and the ability to compete on factors other than price. Our experience is that middle-market opportunities tend to deliver 100 to 150 basis points of higher return on a same sector and jurisdiction basis.

This value proposition for investors is further strengthened by robust deal activity, particularly in transportation, utilities and energy. According to InfraDeals, about 70% of the infrastructure transactions completed in North America in 2015 were US$1 billion or less in value. With the magnitude of local infrastructure needs, there is a huge untapped opportunity for seasoned infrastructure investors to work with municipalities and other MUSH institutions to originate high quality projects.

Emerging opportunities

Our observation is that urbanisation has fundamentally upended traditional infrastructure models, reflecting the mismatch between North America's predominantly mid-20th century infrastructure and the way we live, work and conduct commerce today. Instead of highways, light rapid transit is growing in appeal as a solution to urban congestion due to its cost effectiveness and efficiency. In the water sector, recent droughts and floods along with rising urban water consumption have exposed the dire state of the continent's ageing water systems and shifted focus to wastewater treatment and re-use along with water storage solutions. And demand for new, greener electricity solutions is giving rise to distributed generation, energy storage and district heating projects, with an emphasis on energy savings and efficiency technologies.

Overall, MUSH institutions are under substantial pressure to elevate the condition of their infrastructure at a time when traditional sources of financing are diminishing. This creates the opportunity for greater collaboration with the private sector, including finding ways to leverage existing assets as a means of reducing future infrastructure expansion costs. For example, InstarAGF is working with partner Johnson Controls Inc. to offer new energy infrastructure refurbishment, retrofit and efficiency solutions to the MUSH sector, thereby enabling institutions to monetise non-core assets to secure an immediate source of revenue that can be reinvested in the institution's core purpose while also lowering electricity costs and realising customer service and conservation improvements.

With the massive amount of capital required to meet burgeoning infrastructure requirements, it is inevitable that a wealth of interesting and unique investment opportunities will come to market in the years ahead. More than ever before, private investors will play a pivotal – and unprecedented – role in pioneering, renewing and delivering the essential infrastructure upon which our economies and quality of life depend.

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