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Nuts and bolts assets attract attention

INFRASTRUCTURE FUNDS

Steady and predictable cashflows have fuelled demand from institutional investors, writes **Eric Uhlfelder**

New investments ideas tend to be complex, but the latest fad in institutional investment seems to have rediscovered the attractions of simplicity. Institutional investors have woken up to the idea that nuts and bolts assets can be good plays, and started buying into airports, highways and water networks.

While increasing demand for these assets may lead to capital appreciation, infrastructure investors, led by pension funds, are typically attracted by the steady, predictable cash flows associated with publicly regulated operations.

Meeting this demand for infrastructure products are fiscally strapped governments – across developed and emerging markets – looking to sell-off public assets to help plug deficits and to shift the financing of necessary improvements to the private sector.

Linda McDonald, research analyst of the Connecticut-based consultancy RogersCasey, says: "Acceleration in the number of privatisations combined with the increased appetite of institutional investors for alternative high yielding assets has resulted in a flurry of infrastructure funds to hit the marketplace, while additional firms scramble to put teams in place to launch competing products."

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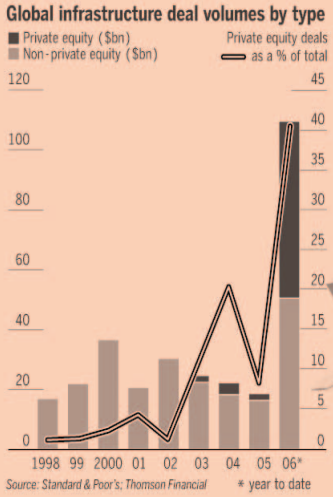
Another appealing quality of economic infrastructure, notes Mike Taylor, chief executive of £3.5bn London Pension Fund Authority, is that rate increases are typically geared to inflation, protecting real returns.



Comprised of 40 per cent utilities, 40 per cent transportation shares, and 20 per cent energy concerns, the Standard & Poor's Global Infrastructure Index has soared 23 per cent a year from November 2001 through January 2007 in dollar terms. That topped S&P's Global 1200 Stock Index by more than 12 percentage points and the Lehman Brothers/ Global Aggregate Bond Index by more than 16 percentage points a year.

The appeal of the sector, according to S&P's index strategist Srikant Dash, goes beyond its market-beating returns. "Infrastructure stocks," he says, "have demonstrated lower annualised volatility than equities, 10.9 versus 12.3 per cent, as well as low correlation to traditional securities: 70.7 versus stocks and 41.4 versus bonds."

Just as intriguing is how the index has apparently sustained its overall valuation despite its soaring performance. Since 2001, Mr Dash found price/earnings ratios have held steady around 18-19, price/book has held around 2.6, and yields have remained around 3.1 per cent.

Mr Dash believes the index has pulled off this legerdemain through annualised rebalancing. "By keeping a constant industry ratio – 30 utilities, 30 transportation shares, and 15 energy shares – the index has generally prevented soaring prices in any one industry from dominating the index."

Stephan Meier, manager of the Zurich-based BZ Infra Fund, has reported this same phenomenon when comparing enterprise value versus gross earnings of two key holdings, each having soared by more 70 per cent over the past year and a half. Change in the enterprise value/gross earnings ratio between 2005 and 2007 of Swiss electricity producer and distributor CKW and Zurich airport operator Unique (which make up nearly 60 per cent of the fund's assets) has nudged up from an average of 9 to 10.3.

"Because both companies retain strong underlying fundamentals and strong cash flow generation, I feel comfortable with their relative valuations and near-term outlook," says Mr Meier. However, he would find it difficult to repeat his fund's 55 per cent gain realised in 2006, especially with the same focused holdings. So he expects to take profits out of these two investments, and spread his largest positions across four stocks. While remaining focused in Switzerland and western Europe, he also intends to tiptoe into the emerging markets of central and eastern Europe.

Jon Fitch manages seven infrastructure funds for Australian-based Macquarie Group around the globe worth $2.2bn. His largest US fund product is the closed-end Macquarie Global Infrastructure Total

Return Fund, which started up in August 2005.

Currently using leverage of 30.6 per cent, the fund has $639m in total assets. And like BZ's Mr Meier, Mr Fitch had a good 2006, enjoying market returns of nearly 40 per cent, according to Morningstar. And year to date through early April, the fund was up more than 18 per cent, while offering an annual yield of nearly 5 per cent.

In spite of several clear risks, Mr Fitch remains sanguine about infrastructure's forward-looking performance. While most operations remain under government oversight, Mr Fitch finds the current regulatory environment generally benign.

"With a risk-return profile that's between fixed income and equities," he says, "inflation is a concern. But the ability to pass on such costs typically mitigates this risk."

And while he recognises the pricing pressures that can come from increasing institutional demand for infrastructure investments, Mr Fitch believes overvaluation may be prevented as more infrastructure comes on line, especially in the US as governments continue to privatise various assets.

However, not all industry observers believe that the economics of infrastructure investing are sustainable given the sector's current pace of growth. For example, many eyebrows were raised when Macquarie and its Spanish partner Cintra agreed to pay $3.8bn for a 75-year lease for a 157-mile toll road in the state of Indiana. That was equivalent to 65 times historic gross earnings.

Michael Wilkins, managing director of S&P's European Infrastructure Finance Group in London, reports that $100-$150bn has been raised globally to target infrastructure investments, while debt raised on some infrastructure deals is pushing toward 30 times underlying earnings.

For Mr Wilkins, the potential of overvaluation and excessive leverage are ingredients of an asset bubble.

So long as there is adequate liquidity and rate increases that match costs of running essential operations, private sector interest in infrastructure should remain strong. How all this translates in terms of future stock price performance is another matter.