Who is afraid of construction risk?

Investment solutions in infrastructure debt are only just beginning to appear

*By Frédéric Blanc-Brude and Omneia Ismail**

In recent research at EDHEC-Risk Institute supported by Natixis[1], we examined the opportunity for long-term institutional investors such as pension funds, insurance companies or sovereign wealth funds, to invest in large portfolios of infrastructure debt, both to manage their liabilities and to minimise their exposure to capital market volatility.

The opportunity for institutional investors to become involved in infrastructure debt matters for two reasons: evolution and adaptation in institutional money management, and public policy. First, infrastructure debt is a fixed-income instrument characterised by long durations and typically high credit quality and, as such, can contribute to meeting institutional investors' long-term objectives. Infrastructure investment has become a theme of increasing interest amongst investors, along with a growing variety of alternative investments, following the 2007-2009 financial crisis and the challenges posed to traditional portfolio diversification using stocks and bonds during that period.

In this context, infrastructure investment is expected to have attractive properties. According to what we call the "infrastructure investment narrative" (Blanc-Brude, 2013), tangible infrastructure assets, immobile and demanding high sunk capital costs and long repayment periods, create monopolies thanks to barriers to entry and increasing returns to scale. Thus, these investments should benefit from low elasticity of demand for the services they provide and low return covariance with other investments. Being predominantly unlisted, they are also expected to pay an illiquidity premium and yield attractive risk-adjusted returns.

Unlisted infrastructure debt can thus combine the attractiveness of illiquid investments with long durations and a focus on cash flows which unlisted real estate or private equity do not necessarily offer.

However, accessing the intuitive characteristics of underlying infrastructure investments such as road projects or utilities remains difficult and underdeveloped, especially on the debt side. Second, the idea that institutional money can be invested in infrastructure projects has given rise to numerous policy initiatives to channel these funds into new infrastructure investment in Europe, the US and beyond.

The objectives of these policies vary, from the development of capital markets, to funding new infrastructure that governments find difficult to finance themselves but may play a role in supporting future economic growth, to creating jobs immediately thanks to investment in large public works.

In effect, such are public sector concerns about the long-term financing of future growth that the European Commission recently asked the European insurance and pension regulator (EIOPA) to consider lowering the Solvency II capital requirements to accommodate long-term investments like infrastructure by institutional investors (Faull, 2012).

From a broader perspective, investing a proportion of pension assets in the development of infrastructure projects which in turn contribute to the improvement of total factor productivity may also be a counter measure in countries with declining demographics, to help make public and private pension systems more sustainable. Thus, insofar as investors can benefit from infrastructure investment, the development of infrastructure debt investment solutions also makes sense from a public policy point of view.

Today, most infrastructure investments by institutional investors, whether they are in listed, unlisted, direct or indirect, have taken place on the equity side. However, most privately developed (and thus investable) underlying infrastructure projects are financed using significant amounts of debt. On average, 75% of new infrastructure project financing requires originating new credit instruments.

From a volume perspective, if infrastructure investing should be on a par with infrastructure financing, it should consist mainly of infrastructure debt. Today, investment solutions in infrastructure debt are only beginning to appear and their development will play an instrumental role in the ability of pension funds and insurance companies to access long-term, cash-flow-oriented assets to help them achieve their liability-driven investment objectives. But for the investment needs of institutional investors to converge with those of the public sector, investment must be made for the most part in new or so-called "green-field" infrastructure projects. So far, however, pension funds and insurance companies have shown little interest in funding new projects, mainly for fear of "construction risk," i.e. the perception that new infrastructure projects entail significantly more risk than existing ones.

In our research, we conclude that investors should embrace construction risk. Not only because construction risk is not as high in private infrastructure investment as investors often imagine, but especially because it should be seen as a welcome diversifier of credit risk in infrastructure debt portfolios. ■

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Reference

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- *Faull, J. 2012. Letter from European Commission to EIOPA.*

[1] Blanc-Brude, F., O. Ismail. June 2013. Who is Afraid of Construction Risk? Infrastructure Debt Portfolio Construction. EDHEC-Risk Institute Publication produced with the support of Natixis.