asset class

Why clearly defining infrastructure is critical

Without a clear definition of what it is and what it can offer investors, the infrastructure sector does itself a disservice, argues Sarah Tame, associate director at EDHEC Infrastructure Institute.

By **Guest Writer** - 2 days ago

A- A+ 100%

Infrastructure as an asset class has evolved over the past 10 years. In that evolution it has taken classifications and definitions from the private equity and real estate world such as core and core-plus.

More recently, asset managers have launched investment products offering value-add strategies and increasingly the line between private equity and infrastructure has blurred.

The trouble with these inherited labels is they provide no clear definition of infrastructure that suits all dimensions and risk profiles of the asset class and often give managers license to make spurious investments.

As infrastructure investment grows in popularity, the boundaries are being stretched even further by some asset managers, investing in real estate-type assets with an infrastructure value-add label slapped on top. Investors are often left confused as to what core, core-plus, value-add and now super-core products encompass. Generally, they are a way for managers to justify return targets.

The infrastructure sector does itself a disservice without a clear structure and definition of the strategies it is able to offer investors. Without a proper taxonomy providing a set of criteria to define infrastructure it is hard for asset managers to structure the solutions investors need.

So, what is infrastructure?

Several definitions of infrastructure already exist. The OECD and World Bank

use definitions based on public policy. Meanwhile, regulators focus on what infrastructure 'is like' in order to qualify it under various prudential frameworks. Under Basel-II and Solvency-II, regulators apply definitions that try to differentiate how infrastructure investments are distinctive from corporate equity or debt, all the while failing to provide a definition unique to infrastructure.

None of these classifications encompass all the characteristics of infrastructure, from business risk profile to industrial expertise. Without this, investors continue to buy into vague strategies with no granular understanding of how infrastructure investments are concentrated in their portfolios.

What if we had a classification that embodied all the characteristics of infrastructure?
The EDHEC Infrastructure Institute, as part of its work to build performance benchmarks for investors in private infrastructure debt and equity, has launched the Global Infrastructure Company Classification (GICCS) to do just that. Taking existing definitions and perspectives into account we have created a multi-dimensional criteria to help asset owners and asset managers classify and define the asset class. Importantly, GICCS is compatible with Basel-II and Solvency-II definitions of infrastructure, which focus on risk profile, but crucially incorporates the unique characteristics of infrastructure.

GICCS comprises four pillars to structure the infrastructure asset class and provide a frame of reference for asset owners and managers. It is designed to be compatible with other standard investment classifications and it takes into account the evolution of the infrastructure asset class.

Four pillars to define infrastructure

• Business risk classification: While infrastructure is tangible, it is wrong to assume the value for investors lies in the hard assets. The infrastructure itself is not the value. It needs to be used to have value. It is the contracts, not the concrete that matter. This is what differentiates infrastructure from real estate.

GICCS sets out three business risk classes: contracted, regulated and merchant. The business risk classification captures the risk-sharing mechanisms of the revenue model of an infrastructure firm. In infrastructure today, we think about

grouping infrastructure by broad industrial categories such as transport and renewables. In practice, the business risk profile of a merchant toll road has more in common with a merchant power plant than an availability-based road project.

• Industrial classification: Standard industrial classifications can be ill-suited to represent different types of infrastructure companies. For example, an airport operator and an airline catering company are typically bundled together under the banner of transport infrastructure. GICCS puts forward a very granular taxonomy of industrial activities and technologies and asset-level characteristics that capture the potential diversity of infrastructure companies' services and products. For instance, transport projects have common technical and industrial features, as do renewables and social infrastructure projects, which correspond to broad groups of professionals that have the relevant know-how to understand and execute individual transactions.

• Geo-economic classification: Infrastructure assets are obviously fixed in space but their economic exposure is dependent on use rather than location. Therefore, it is important to classify infrastructure investments by their exposure to different geo-economic levels of the economy they serve.

The GICCS geo-economic classification reflects whether an asset is exposed to local, national or global economies. For example, large transportation hubs such as major airports and ports are exposed to global economies despite not being co-located. On the other hand, a global container shipping port and a regional port can be less correlated with one another even though they may be in close proximity and have relatively similar business models.

• Corporate governance classification: The behaviour of an infrastructure company differs depending on whether it was created to develop a single project (infrastructure project) or multiple projects (infrastructure corporate). This behaviour has an impact on the business risk profile of the asset. GICCS puts forward two corporate governance classes to structure the asset class.

Infrastructure project companies are created in the context of a long-term contract between an investor and a public or private sector client with the aim of developing a single project and their incentives to take risk are minimised by

their financial structure. Infrastructure projects are highly leveraged and this plays an important disciplinary role as well as being a signal of creditworthiness.

An infrastructure corporate, however, is akin to a traditional corporate. Managers have the freedom to make investment decisions that change materially and strategically over time. They are also free to change their financial structure and can use multiple sources of public and private financing. Debt can be used to increase returns on equity and creates incentives to take risks.

The popularity of infrastructure investment is undoubtedly on the increase. It is vital now more than ever that it differentiate itself from private equity and real estate with clear definitions and structure. Without this, investors will be sold mistruths and will never truly be able to integrate infrastructure into their wider investment portfolios. Ultimately, this will stunt the growth of the sector and will prevent the allocation of capital to vital infrastructure development.

GICCS will enable investors to group infrastructure investments in a more structured way. It can define investment styles and will enable asset managers to design investment strategies that articulate the characteristics of infrastructure more effectively. In turn, it can be used to define benchmarks for each strategy. And it will enable asset owners, managers, regulators, banks and advisers to structure the sector, and document the investible market for infrastructure for the next 10 years and beyond.