

# Top 10 with...

Interview with **Tommaso Albanese** on Infrastructure Equity

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## Infrastructure Equity facts

2006

Business established

USD 2.2bn

AuM, direct  
infrastructure equity

A+

Infrastructure rating  
in UN-PRI's annual  
sustainability  
assessments

Highly diversified

Across infrastructure  
sectors and  
geographies

Data as of 30 June 2019



**Tommaso Albanese**, Head & Chief Investment Officer of Infrastructure

## Stable and long-term cash flows in a growing market

Infrastructure equity is a growing global asset class which can offer attractive returns to investors. Investor sentiment coupled with the record levels of dry powder in the market has increased demand for this high-yielding asset class. How is the REPM Infrastructure business capitalizing from this market growth to benefit clients?

# 1

## **What type of investor is suited for private infrastructure equity and why?**

Investors who focus on yield and managing long-term liabilities, such as pension funds and insurers, will find infrastructure assets attractive. In addition to benefiting from enhanced diversification, these investors can use infrastructure to help match their liability profile with a predictable and (partly) inflation-linked distribution stream. Given its relatively low correlation with traditional asset classes, infrastructure can also play a valuable role in the risk-return optimization of a portfolio and should be considered in strategic asset allocation decisions.

The popularity of infrastructure assets is increasing among investors as it offers reliable long-term cash flows, usually with some form of inflation protection. Infrastructure funds that offer longer-term, high-yielding, defensive, risk-adjusted returns are well-suited to pension funds and other long-term oriented investors seeking steady, reliable returns. It's also important that investors looking at infrastructure consider the illiquidity of investments. Likewise with other real assets, infrastructure is a long-term investment that can include lockups of 10-plus years.

# 2

## **What strategies are your business pursuing?**

We believe that the best opportunities lie with traditional infrastructure with core/core+ characteristics that can generate strong cash yields. In particular, we focus on mid-market transactions rather than on the large deals where many infrastructure managers are involved. When you compare them with large cap deals that tend to be originated through a competitive bidding process, mid-market deals are often originated on a bilateral basis or with limited competition. Large Value-Added and Opportunistic strategy funds raised 57% of the total capital raised during the latest 3Q19 period<sup>1</sup>. Only a limited number of managers like us are focused on the traditional mid-market. Such a focused approach allows us to originate traditional infrastructure with attractive returns and high cash yields.

When we acquire an asset, we take a leading role in the long-term active management of our portfolio companies so that we can improve operations when possible. In addition, we seek board (or similar) representation where we represent our interests and engage with the executive management to ensure strong governance. This helps us to improve and sustain the long-term operational performance of the businesses and deliver the business cases committed to at acquisition. We do this through astute and diplomatic direction of management, while giving the executive management team autonomy in their roles.

# 3

## **Investor sentiment for infrastructure equity is currently at record highs. Why has the appetite from investors increased?**

Investors' strong appetite for infrastructure was reflected in 2018, another record year for capital fundraising. The volume of funds raised in 2018 of USD 90bn exceeded the previous fundraising record of USD 75bn set in 2017. According to Preqin, 84% of investors surveyed felt infrastructure had met or exceeded their expectations; 35% planned to commit more capital to infrastructure funds in 2019 than the previous year<sup>2</sup>.

Many institutional investors are increasing their allocation to infrastructure equity funds for a few key reasons. A major driving factor is the sector's strong returns in today's low-yield environment. Infrastructure is a typical income-based strategy, providing stable predictable long-term cash flows. Investments are mostly on essential capital-intensive businesses with high operating margins, which perform well across the entire economic cycle. This asset class provides a natural diversification benefit. Historically, it has a low correlation with other asset classes, namely equities, government bonds, corporate bonds and even listed infrastructure.

<sup>1</sup> Preqin Quarterly Update: Infrastructure 3Q19. <sup>2</sup> Preqin 2019 Global Alternatives Report

# 4

## **Has this increased appetite caused a shift in investment approach?**

The growth of the infrastructure sector means that investors now have a choice of managers across the risk-return spectrum. An increased appetite has led to more competition for attractive deals, further leading to compressed returns. As a result, many infrastructure managers in the market have repositioned themselves strategically to take more risk in order to reach higher returns. These strategies tend to rely on capital gains when the asset is later sold.

However, in the current mature stage of the cycle and with elevated asset valuations and increased volatility in the listed markets, a capital appreciation-based strategy could come under pressure. Instead, an income-based strategy with a more conservative IRR but a much higher cash yield distributed year after year would more naturally benefit from the infrastructure sector's characteristics.

There has also been a bifurcation between mega funds that focus on large mainstream assets and funds with more tailored strategies (such as by region or sector). UBS has consistently been focused on high income-based strategies – in particular the middle market segment – that could still provide attractive risk-return investment profiles for more traditional infrastructure assets, but require specific and local expertise.

# 5

## **With the current political environment in Europe, how do you find this affects risks and opportunities for investments?**

Weak government finances, especially in many developed countries, represent another important issue for infrastructure investors. Fiscal stress suggests that private capital will increasingly be needed for financing infrastructure.

However, a broader rise of populism in governments is turning the focus on affordability, meaning that infrastructure investment is becoming more politicized. Regulators are coming under pressure to demonstrate that they are not generating excess profits in key social assets, while the private sector could be more effective in showing how it has been adding value in infrastructure. For example, we are proud of our recent investment in Gascan, a Portuguese liquefied petroleum gas network that provides ca. 11,000 tons of natural gas per year to roughly 65,600 Portuguese customers. While not regulated, the network primarily serves the Algarve region, where natural gas network coverage was previously limited due to low population density, and therefore resulting in an essential local utility with a strong market dominance.



**Axicom**, Australia mobile telecommunication towers operator

Infrastructure investors have a proven track record as owners of telecommunication assets. However, 2018 is the year when telecommunications infrastructure entered into the mainstream.

# 6

**The transmission of data and new technologies is creating more opportunities for investors. Would you agree?**

Data infrastructure is undeniably one of the fastest growing and exciting sectors to invest in. The proliferation of high definition on-demand video, gaming, cloud services, mobile data usage and IT outsourcing has created a surge in both fixed and mobile internet traffic, and this growth is forecast to increase exponentially. This increasing demand has helped create a competitive market for data-related infrastructure assets.

Infrastructure investors have a proven track record as owners of telecommunication assets. However, 2018 is the year when telecommunications infrastructure entered into the mainstream, accounting for more than 30% of invested capital in infrastructure to 3Q18<sup>3</sup>. A majority of these investments were in the newer sub-sectors within data infrastructure; ie. fiber, data centers and, to a lesser extent, "smart" infrastructure. Investors have been very active in the fiber space, completing investments in both fiber backbone (trunk network) and rolling-out FTTP (last mile connections). The continued rollout of 5G, the next generation of mobile coverage, further adds to the need to develop fiber backbone.

Data centers are also an interesting and vastly expanding space. Some investors follow a more real estate-type long-lease investment strategy while others invest via the private equity angle that takes more operating and technology risks. Data center activity is projected to approximately double between 2017 and 2021.

Finally, we have "smart" infrastructure, which can widely be defined as the combination of technology and data to improve productivity and efficiency. Examples of smart infrastructure range from smart meters used in the water and electricity sectors, to electric vehicle charging points that are becoming more commonplace, to digital waste bins that communicate when they are full. Overall, smart infrastructure initiatives cover transportation, energy, security and environmental services, all essential elements of a sustainable society.

# 7

**In which regions and sectors are you finding the best investment opportunities?**

In general, we believe that OECD-developed countries present the best opportunities for traditional infrastructure investments. The attractiveness of specific sectors depends on the particular region. In North America, the energy sector is standout. Opportunities have arisen from the evolution of the energy mix, the increased importance of renewables and alternative fuels – including geothermal, biomass, landfill gas, combined heat and power – and high growth areas such as behind-the-meter generation and storage, energy efficiency and battery systems.

In Europe, investment activity is more diverse. In addition to the energy sector, transportation assets (regional airports and secondary hubs), regulated and unregulated utilities (the growing district heating market), and telecommunication assets (the build-out of optical fiber infrastructure) all present good opportunities.

In Asia Pacific, Australia represents a unique investment environment. In particular, the most attractive opportunities are (i) in the energy sector, where the cleaner energy mix is expected to drive higher gas demand; and (ii) in the telecommunications sector, where growing data demand and regulatory changes are expected to shift towards wholesale-only suppliers of telecommunication infrastructure.

<sup>3</sup> Preqin 2019 Global Alternatives Report

## 8

**Infrastructure managers are now offering closed-ended and open-ended funds. What are the advantages and disadvantages of each type?**

Closed-ended and open-ended funds differ in a handful of meaningful ways. In terms of fees, open-ended funds' management fees are based on NAV, which implicitly includes a performance fee. Whereas with closed-ended funds, a performance fee is charged only upon realization. Ultimately, depending on the terms of the performance fee this can have a large effect on the bottom line fees that investors pay.

One key difference is that open-ended funds can offer more liquidity than closed-ended funds, either by matching incoming and outgoing investors or through limited redemption rights. However, the frequency of liquidity (quarterly, semi-annually, etc.) may not be guaranteed and there may be additional fees associated with redemption requests. Some open-ended funds impose an initial lock-up period of up to four years.

With open-ended vehicles, valuations can pose a recurring challenge. Given the liquidity that these funds offer, valuations of the underlying unrealized illiquid infrastructure assets are more frequent. The additional valuation effort can lead to higher costs. Furthermore, frequent valuations of unrealized illiquid assets could lead to unrealistic price volatility due to the lack of reliable market references.

## 9

**More investors are recognizing the importance of ESG considerations and also believe sustainable businesses outperform over the long term. What are you doing in this regard?**

Responsible ownership and operation is integral to how we actively manage our infrastructure investments. Environmental, Social & Governance (ESG) considerations are memorialized in our investment and asset management process. We also follow a formal ESG policy. When considering new investments, we rigorously vet the ESG aspects of each opportunity. Our ESG framework is based on three components:

- (i) *Environmental sustainability* – maintaining capacity of the ecosystem to provide raw materials as inputs, and sink capacities to assimilate waste over multiple generations;
- (ii) *Social responsibility* – taking responsibility for our impact on society by integrating social, environmental, ethical, human rights and consumer concerns into business operations and funds; and
- (iii) *Good governance* – being consistent with the rule of law, protecting and facilitating the exercise of shareholders' rights (ensuring equitable treatment of shareholders and encouraging active co-operation of stakeholders to ensure timely and accurate disclosure); and promoting board effectiveness to guide fund and monitor management, thereby requiring the board to remain accountable.

UBS Asset Management has been an early adopter of the GRESB Assessments, contributing data since 2012. Our Saubermacher asset held by our first closed-ended global infrastructure fund retained its "Overall Asset Sector Leader" status in Environmental Services for the second consecutive year (2019), demonstrating outstanding leadership in sustainability. Furthermore, Autovia del Camino S.A.U., an asset held by another closed-ended global infrastructure fund, ranked first in its peer group. We also received an A+ for Property and Infrastructure in the 2019 UN-PRI Assessment. We have been at the forefront of leading sustainable projects. Our Swiss Clean Energy initiative, launched in 2013, provides institutional investors with access to a Swiss diversified portfolio of infrastructure investments and companies in the growth areas of sustainable energy production, energy efficiency and supply infrastructure.

Marrying the capital requirements of the energy sector with the demands of institutional investors, the investment platform fulfills an important gap in the industry. The popular vote in favor of the Energy Act underpins the Swiss Federal Council's Energy Strategy 2050. The strategy prioritizes energy policies that promote energy efficiency as well as "new" renewable sources such as solar, wind and hydropower. At the same time, many institutional investors are looking for long-term investments offering stable returns in the current low-interest-rate environment. Following continued investor demand, we launched a second Swiss Clean Energy fund in 2017.

### **Phoenix Wind,**

US wind farm located in Texas

UBS has a long track record of sustainable investment, highlighted by our recent investment in Phoenix Wind, a portfolio of three wind farms in Texas, US. The wind farms are expected to provide 383 MW of electricity to the Texas power market (ERCOT), which delivers electricity to more than 25 million customers and includes more than 78,000 megawatts of capacity to meet customer demand. Texas has the most wind generation of any State, and ERCOT's power demand is expected to grow by almost 3% per annum (p.a.) over the next decade (vs. an average of approximately 1% p.a. for the US). By generating and delivering clean renewable electricity into the power grid the wind farm displaces about 1,140,000 metric tons of emissions each year, equivalent to taking 242,000 passenger vehicles off the road every year. Overall, it produces enough energy to power approximately 137,000 homes in Texas.



# 10

## **What are the key lessons you've learned over the years for investing in infrastructure?**

To date we have invested in two global portfolios diversified across regions, sectors and stages as well as revenue drivers (regulated, contracted and GDP). We have focused on managing existing investments to reduce risk and increase efficiency and to overcome challenges to preserve value. We have worked with management to optimize investments to deliver cash flows and – where applicable – prepare assets for exit.

Over the past five years, we have seen a material compression on return expectations for traditional infrastructure assets. To adjust to the higher valuations on infrastructure assets, it can be tempting to delay capital deployment. While it is important to maintain a cautious stance towards changes in cycles, it is also important to remain agile so you can react efficiently to new opportunities, such as telecommunication and data infrastructure.

From a geopolitical standpoint, we have found that regulated assets can prove challenging with valuations leaving little room for underperformance and/or regulatory changes. This phenomenon has recently started to occur even in highly developed economies. Instead, the more attractive opportunity is often in unregulated utilities, which still deliver essential services to a large customer base.

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