EDHECinfra

Defining infrastructure investment strategies

A Q&A with Frederic Blanc-Brude

CONTRIBUTOR

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Frederic Blanc-Brude is the director of EDHECinfra, an index, analytics and research provider specializing in the provision of unlisted infrastructure equity and debt market indices and custom benchmarks. Before joining EDHEC in 2011, he spent 10 years in the infrastructure finance field with direct involvement in more than $6 billion of transactions. He is a regular contributor to the G20 working group on long-term infrastructure investment, has advised the European Occupational Pensions and Insurance Authority on the prudential treatment of infrastructure investments and also represents EDHEC on the Advisory Board of the Global Infrastructure Facility of the World Bank. Blanc-Brude is a member of the Editorial Board of *The Journal of Alternative Investments* and is a regular contributor to the press. He also chairs the management committee of TICCS®, The Infrastructure Company Classification Standard.

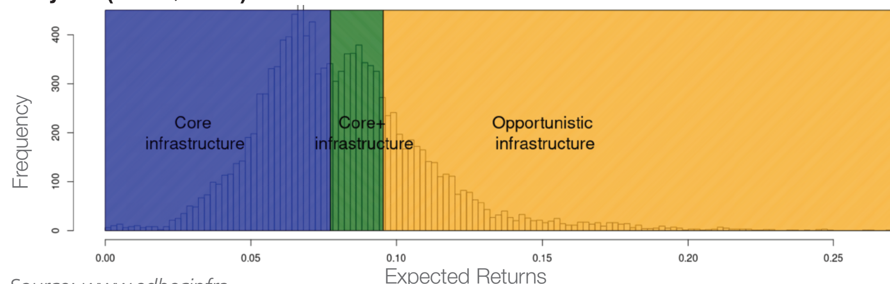
What differentiates core, core-plus, opportunistic and mid-market strategies in the unlisted infrastructure equity space?

There are no universally accepted definitions of core, core-plus or any of the main strategies. The notion of "core infrastructure" relies on several intuitions about the inherent stability and essential aspects of the business of certain infrastructure companies (e.g., water and gas networks), but investors also know that some investments are riskier than others and may, for example, include a degree of market risk. Infrastructure investment also means taking greenfield or country risks, which can further change the risk profile of the investment toward so-called opportunistic assets.

Hence, the difference between core, core-plus and opportunistic is intuitively about risk appetite and expected returns. Indeed, investors require higher returns to be exposed to riskier investments. Thus, you may want to define these strategies as the different quartiles of the distribution of expected returns. (See Figure 1).

Core infrastructure is the first two quartiles of the distribution of expected returns, covering the lower part of the risk spectrum. Core-plus is a riskier slice of the market, defined as the third quartile of expected returns. Opportunistic is anything with expected returns in the highest quartile, also signaling higher risk.

Figure 1. Distribution of expected returns for core, core-plus and opportunistic strategies over past five years (as of Q2 2021)



Source: www.edhecinfra

Table 1. Gross risk-return profiles of core, core-plus, opportunistic and mid-market strategies

Infrastructure Type	Total Returns				Risk (Volatility)			COVID-19 Draw-down**	Cash Yield	Pct. Emerg-ing
	Q2 2021	12-mo.	3-year*	5-year*	3-year	5-year	10-year			
Core	3.3%	6.1%	9.0%	8.8%	7.8%	7.0%	10.2%	–4.9%	9.1%	0%
Core+	6.0%	9.6%	13.5%	11.4%	11.5%	9.6%	12.3%	–6.3%	8.2%	0%
Mid–Market	3.8%	7.4%	12.7%	10.8%	10.7%	9.2%	10.9%	–6.7%	8.3%	12%
Opportunistic	7.1%	7.8%	12.0%	10.3%	20.4%	16.1%	12.8%	–11.6%	7.6%	30%

*Source: www.edhecinfra *Annualized **Maximum drawdown since Q1 2020; Data as of Q2 2021, local currency returns*

Meanwhile, investors in the mid-market space argue that the larger asset segment of the market is crowded, with large investors chasing large "trophy" assets, and that mid-size investments are more likely to be priced attractively. Defining this style is straightforward — we consider any asset in the second and third quartiles of the size (total assets) distribution of available investments.

The data (see Table 1) confirms that the quartiles of expected returns capture different levels of risk. Volatility is higher for opportunistic and, to some extent, core-plus investments. Core infra is clearly less risky. In terms of the volatility of total returns, of the drawdown experienced in March 2021, as COVID-19 began to affect asset prices, and of the exposure to emerging markets of each strategy, core has the lowest risk and the lowest returns.

The core-plus style can seem close to opportunistic infra. This is driven by several factors, in particular the crowding of the core-plus trades, which have boosted prices, compressed discount rates and resulted in more significant capital gains for investors in this segment.

The cash yield of core-plus assets is also higher than that of opportunistic trades. Finally, more of the opportunistic segment is exposed to emerging markets where rates have been higher than in advanced economies, where very low rates further increased capital gains by contributing to lower market discount rates.

Core-plus and mid-market infrastructure turn out to have comparable risk profiles, but core-plus performed better historically, also because of capital gains realized on larger assets that meet the core-plus expected return criteria.

How have these strategies performed over time? Can you identify the better-performing strategies? What about expected returns?

All these strategies have benefited from a repricing over the past 15 years, which contributed significantly to their double-digit annualized performance over that

Table 2. Expected returns of core, core-plus and opportunistic infrastructure strategies

Infrastructure Type	Q2 2021	1 year ago	3 years ago	5 years ago	10 years ago
Core	3.3%	6.1%	9.0%	8.8%	7.8%
Core+	6.0%	9.6%	13.5%	11.4%	11.5%
Mid–Market	3.8%	7.4%	12.7%	10.8%	10.7%
Opportunistic	7.1%	7.8%	12.0%	10.3%	20.4%

Source: www.edhecinfra

period. This yield compression is universal across strategies: Core expected returns, as measured from secondary-market transactions, have fallen by almost 40 percent over the past decade, to less than 6 percent in 2021. Likewise, core-plus and opportunistic now exhibit expected returns of 8 percent-plus and 12 percent-plus, down from 13.7 percent and 18 percent, respectively, a decade ago. (See Table 2.)

Such strong historical performance is sometimes a source of confusion when looking at a benchmark for different strategies. Unlike stocks, for which the long-term mean reversion of the equity risk premium allows investors to use historical time series to build expected return views, unlisted infrastructure is a new asset class, which has been repriced since it became more popular with institutional investors. To put it simply, 15 years ago, infrastructure was "cheap." The hurdle rates of equity investors — mostly large construction companies investing equity in their own projects — were also higher. Other investors in infrastructure 15 years ago were pioneers. The asset class was opaque, liquidity/exits were mostly unknown and senior debt was more expensive.

Today, the asset class is more *de rigueur.* Most large investors allocate explicitly to infrastructure, and the demand for these assets has increased considerably. The market price of unlisted infrastructure equity risk has therefore declined accordingly, creating large one-off capital gains. Infrastructure is now priced for the institutional market and is a better understood and increasingly better documented asset class. Hence, expected returns are now lower than realized historical returns.

Opportunistic strategies, with their higher risk exposures, deliver the highest cumulative performance, while core has the lowest performance but with a comparable risk-return trade-off. Until 2017, the unlisted infrastructure equity risk premia (not shown) decreased steadily before stabilizing. From 2018 onward, new cuts in interest rates added to previous capital gains. The market peaked in late 2019, first because of a steepening of the yield curve, and then in 2020, with the COVID-19 lockdowns, which impacted cash flows but also increased the unlisted infrastructure equity risk premia on a scale not seen since the 2012 euro debt crisis.

Since then, all strategies have returned to positive returns, with the strongest rebound in the opportunistic segment. Core-plus and mid-market are close, at about 8.5 percent expected returns in second quarter 2021. Core can be expected to yield less then 6 percent (even less in the renewables space).

How are core, core-plus, opportunistic and mid-market strategies exposed to the different characteristics of the asset class?

The four strategies entail different exposures to the asset class. Table 3 shows their exposure to each pillar of The Infrastructure Company Classification Standard (TICCS®). Indeed, rather than sectors, which can include very heterogenous assets, each strategy or style corresponds to a combination of asset-level characteristics.

Core is primarily made of "contracted" businesses (companies that benefit from long-term revenue contracts). These are also mostly project finance vehicles (89 percent), and one-third comprise the renewables space (wind and solar), while another third consists of transport PPPs.

Merchant assets, which are exposed to demand risk, tend to belong to core-plus (almost one-third) and, especially, opportunistic styles (about half). Mid-market, in comparison, is a different style insofar as it includes as much merchant infrastructure as core-plus, but much more contracted and less regulated assets. Indeed, regulated assets tend to be large; hence they are found in core-plus strategies.

Core-plus and opportunistic also tend to include a larger share of corporates, such as utilities and airports, even though project finance constitutes at least 60 percent of the exposure to different corporate structures.

From a sector standpoint, as styles become riskier, the exposure to the transport sector increases from one-third to more than 40 percent (and more of these transport assets are also merchant). The same is true of the power sector. Conversely, riskier strategies are less exposed to contracted projects, such as renewables and social infrastructure.

With more and better analytics, we think that infrastructure investment styles are now better understood by investors and better used in the portfolio. (Data available on the EDHECinfra platform: analytics.edhecinfra.com).

Table 3. TICCS exposures of core, core-plus, opportunistic and mid-market strategies

Infrastructure Type	Business Models			Corporate Structure		Industrial Activities							
	Merchant	Contracted	Regulated	Projects	Corporates	Renewables	Env. Services	Net. Utilities	Data Infra	Social Infra	Transport	Power	Nat. Resources
Core	8.4%	80.3%	11.3%	89%	11%	32.9%	5.5%	1.5%	0.4%	17.5%	29.2%	8.8%	4.4%
Core+	27.7%	44.5%	27.7%	61%	39%	8.8%	1.5%	27.0%	0.7%	9.5%	32.9%	11.0%	8.8%
Mid-Market	26.5%	64.6%	8.8%	86%	14%	17.7%	2.8%	5.5%	1.7%	13.3%	37.0%	17.1%	5.0%
Opportunistic	49.6%	35.8%	14.6%	67%	33%	14.6%	0.7%	11.0%	3.7%	4.4%	40.9%	20.4%	4.4%

Source: www.docs.edhecinfra.com/display/TICCS

CORPORATE OVERVIEW

EDHEC Infrastructure Institute Singapore (EDHECinfra) is a venture of the renowned international EDHEC Business School, and is an index data, benchmarks, analytics, and research provider for investors in the unlisted infrastructure universe. We have built the largest, most representative database of underlying infrastructure investments in the world. Indices we provide help investors to measure the risk-adjusted performance of private infrastructure debt and equity within their portfolios. Our indices use the latest market information to measure the fair value of thousands of unlisted infrastructure debt and equity investments in 25 countries. We can also create customized benchmarks for individual investors who require specific TICCS® tilts in their portfolio benchmark. Our research hub, a team of experts who create and maintain our indices, is based in Singapore. We also have a business center in London to serve the financial community in Europe and North America. **http://edhec.infrastructure.institute.com**

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